The investment behaviour of Taiwanese in mainland China

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Abstract

This thesis studies the patterns of Taiwanese investment behaviour in China. It also analyzes the implications on current economic, cultural and political trends and appraises the determinants influencing the Taiwanese direct investment (TDI) in China.

As an active force in the economic development of the world, China is attractive to enterprises and producers from all over the world. Despite the complicated political environments between China and Taiwan, the Taiwanese have been investing in China for years. The increasing TDI in China is because of Taiwan's own depressed economic, political and social conditions, as well as FDI incentives offered by the Chinese government. Ethnical and language issues, as well as *guanxi,* also play important roles in this whole business process.

Besides the above motives, this study also points out that an important motive for TDI in China is that Taiwanese industries are based on a 'subcontracting system', a unique international production/distribution network in East Asia, seen especially in Chinese regions. The motives of FDI from Taiwan into China are very different from the motives of FDI based on oligopolistic enterprises. TDI in China tends to involve an entire Taiwanese 'industrial migration', instead of the movement of firms due to the Taiwanese subcontracting system.

This thesis aims to contribute to the study of FDI on Taiwanese firms which have mainland based ventures. This thesis attempts to provide an overall picture of TDI in China by exploring the investment motives, industries, and locations over a set time span.

This thesis examines the determinants of locational choices on TDI in China based on a conditional logit model. Similar to Hou and Zhang's study (2001), my empirical results find that there is strong evidence of structural change on the determinants of locational choices of TDI in China over time, especially for infrastructure and labour costs. The factors behind this structural change include China's WTO entry and cultural links supported by the FDI policy. The results also show that the technology transfer from TDI into China has been significant for my sample period

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Table of Contents

List of Figures and Tables

List of Abbreviations

ARATS	Association for Relations across the Taiwan Straits (China)
BOFT	Board of Foreign Trade (of Taiwan)
CJVs	Contractual Joint Ventures
DPP	Democratic Progressive Party
EJVs	Equity Joint Ventures
ETDZs	Economic and Technological Development Zones
FDI	Foreign Direct Investment
FIEs	Foreign Invested Enterprises
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
JSCs	Joint-stock Cooperatives
JVs	Joint Ventures
KMT	Kuomintang
MAC	Mainland Affairs Council (of Taiwan)
MNEs	Multinational Enterprises
MOEA	Ministry of Economic Affairs (of Taiwan)
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce (of China)
MOFERT	Ministry of Foreign Economic Relations and Trade
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NICs	Newly Industrializing Countries
NIEs	Newly Industrializing Economies
OCCs	Open Coast Cities
ODM	Original Design Manufacturer
OECD	Organisation for Economic Co-operation and Development
OEM	Original Equipment Manufacturer
PLC	Product Life-Cycle
RMB	Renminbi (China's currency)

SEZs	Special Economic Zones
SMEs	Small and Medium Sizes Enterprises
SSB	State Statistical Bureau (of China)
TDI	Taiwanese Direct Investment
UNCTAD	United Nations Conference on Trade and Development
WOEs	Wholly Owned Enterprises
WTO	World Trade Organisation

Chapter 1 Introduction

1.0 Introduction

Taiwan has had a history separate from China for more than 100 years. In 1895, a military defeat forced the Qing Dynasty to cede Taiwan to Japan (Hsu, 1990). In 1945 after the defeat of Japan in World War II, Taiwan was restored to the Chinese Nationalists. Four years later, the defeated KMT forces retreated to Taiwan after losing the civil war to the Chinese Communists (Tien, 1992).

General Chiang Kai-Shek, the leader of the Nationalists, set up a Chinese government in Taiwan in 1949 and declared the communist regime on the mainland to be illegal. Since 1949 China has been divided and ruled by two separate governments and the Chinese people have lived under different ideologies and contrasting political, economic, and social systems on either side of the Taiwan Strait (Tien, 1992). Since then, the rivalry between Mainland China and Taiwan has defined the context in which the Taiwanese conduct their business activities. The issues of the relationship between Taiwan and China, and the question of reunification have dominated the cross-Strait trade and investment.

Despite political conflicts between China and Taiwan, the Chinese market represents a huge attraction for Taiwanese firms. Being a success story of economic reforms, China achieved an average annual growth rate of 9.4 % in its real GDP growth from 1978 to 2003, outperforming far and away any other transition economies. This development was accompanied by China's integration into the global market. Its overall share in world trade increased from less than 1 per cent in 1979 to about 6 per cent in 2003 (Prasad, 2004), which demonstrates that China has become an important actor in the international economy (Zhang et al., 2005).

The hostile status between two sides of the Taiwan Straits has gradually been changing in recent years mostly because of the economic connections between the two sides. In recent years, as a result of China's Open Door Policy since 1978 and Taiwan's lifting of martial law (*jieyan fa*) in 1987, Taiwanese investors have been able to access China's markets, land and labour resources. In view of Taiwan and China's long-term hostile relationship, this represents a considerable change for both China and Taiwan's attitudes towards each other. The opening of China's markets is a boon to both sides on the Taiwan Straits as some evidence shows that trade and economic links between China and Taiwan during recent years have increased their interdependence, and reduced the hostility between the people in both areas (Chang and Chang, 1992). Existing studies (e.g. Yang, 1997; Hou, 2002; Breslin, 2002; Chen and Ku, 2003; Kastner, 2005) agree that the large number of Taiwanese investors have had significant political and economic influences on both sides of the Taiwan Straits.

As a result, "cross-Strait economy"(*haixia jingji* 海峡经济) has been one of the most important issues surrounding China and Taiwan recently. Given the very broad parameters, including the political, economic, ethnical, historical, and cultural issues, between Taiwan and China, this thesis focuses on the Taiwanese direct investment (TDI) in China.

There are some issues about the definitions of the words, "Chinese" and "Taiwanese". In this thesis, the author defines Chinese as those people who are living in Mainland China, and Taiwanese as those people who are living in Taiwan.

This thesis focuses on Taiwanese direct investment (TDI) in China. Wei et al. (2004) suggest that it must be noted that in Chinese statistics all investment from outside Mainland China is regarded as being "foreign". For example, direct investment from Hong Kong, Macao and Taiwan is recorded as foreign direct investment (FDI) (Wei et al., 2004). When there is need to differentiate between investors from Taiwan and those from other countries, this study will term such investment as TDI (Taiwanese Direct Investment), so as to distinguish it from the broader FDI in China.

1.1 Motivation

The motives of this study are traceable to the economic changes taking place in China and the linkages with its neighbouring economy, including Taiwan, and the global economy.

In 1994, these three economies of Mainland China, Hong Kong and Taiwan became the fourth largest exporters in the world. There is a large body of literature on the concept of Greater China (e.g. Shambaugh, 1995; Huntington, 1996; Rowley and Lewis, 1996; Lin and Lin, 2001), which means the emergence of an integrated economy that spans the national boundaries of the "Chinese" states – Macao, Hong Kong, Taiwan and Mainland China (Breslin, 2003). Huntington (1996) used the phrase "Greater China and its co-prosperity sphere" to define this process. Mainland China is the largest recipient of FDI in the world (World Investment Report, 2004, UNCTAD), and most of that investment originates from Hong Kong and Taiwan (Fung, 1997; Arabi, 2005). China's economic growth has been achieved through gradual economic reform and FDI in China's domestic economy since 1978. The statistics show that Hong Kong and Taiwan's investors surpass all other investors.

Although China and Taiwan's economic systems have differed over the past few decades, the Mainland Chinese and Taiwanese share common culture, values, and language, as well as strong family and village ties (Rauch, 1999; Lau et al., 2002; Huang et al., 2004). Due to ethnicity and language similarity, Taiwan's economy and politics have been strongly linked to China's. The older of the ethnically Chinese inhabitants of Taiwan, which are usually designated as 'Taiwanese' originated from Fujien province, a coastal province of Southern China. In addition the retreat to Taiwan of the Nationalist forces of Chiang Kai-Shek in 1949 brought large numbers of Mainland Chinese soldiers and officials to Taiwan. Thus, many people in Taiwan still have strong feelings about Mainland China. Also, Mandarin is both Taiwan and China's official language, which allows Taiwanese investors to do business in China much more easily. Thus, because of

this ethnical and linguistic similarity, Taiwan's economy and politics have been strongly linked to China's.

Apart from cultural links, Taiwanese enterprises are increasingly attracted by China's immense domestic market. Investment in China represents a new future, which presents a chance to become a world-class company in terms of an opportunity to be reborn and have an international manufacturing scale. It will help Taiwanese companies become not only more active in China's domestic industry but also more competitive in Asia and even in international industry. Cross-Strait economic exchange has accelerated the ongoing economic restructuring process in Taiwan. Therefore, many concerns of the cross-Strait exchange are raised from an economic perspective (Tung, 2000).

The Taiwanese government, however, takes the issue of Taiwanese Mainland-based investment very seriously and is wary of too much economic dependence on China. Many Taiwanese policymakers believe that greater economic ties with the Mainland will help to stabilize the relationship and reduce the likelihood of a Chinese invasion. Opponents of closer ties with China contend that such policies will accelerate the transfer of Taiwanese firms to the Mainland, leading to a hollowing out of core industries, and raising the level of unemployment in Taiwan. Another major concern is over becoming too economically dependent on the Mainland and thus becoming more vulnerable to political pressure from China (Morrison, 2003). As a result, the Taiwanese government has implemented measures to reduce the island's investment reliance on China.

To some extent, the complications of cross-Strait economic exchange have been distorted in the political confrontation between Taiwan and China and thus have impeded bilateral economic cooperation. Many Chinese and Taiwanese, however, believe the issue between the two sides of the Taiwan Straits is a political question. Furthermore, business links seem to provide a solution in decreasing the mutual hostilities and suspicions. To maximize the mutual benefits for both Taiwan and China through economic exchange and/or cooperation, there is a need to clarify the determinants of Taiwanese direct

investment into China because there are policy implications for policy makers in both China and Taiwan.

1.2 Objectives

This thesis aims to analyze the determinants of locational choices of Taiwanese direct investment (TDI) in China with the following expectations:

- To explore the definition of FDI and the concept of FDI theories.
- To review the scope of multinational companies (MNCs) FDI in China, including the country of origin of MNCs, the geographic distribution, and the determinants and entry modes of FDI in China.
- To review the scope of TDI in China, the geographic distribution of TDI in China, the motives for TDI into China and the determinants of TDI in China.
- To explore the relationship between Taiwan' subcontracting system and TDI in China.
- Based on the review of FDI theories and the justification of FDI theories, to construct a theoretical or conceptual framework that elaborates the possible relationship between the TDI determinants and Taiwan's FDI decisions in China.
- To develop a set of determinants of locational choices of TDI in China and hypotheses of the determinants based on the theoretical or conceptual framework constructed earlier. This econometric model aims to answer two questions. First, examine labour quality variable because it has policy implications for the Chinese and Taiwanese governments. Second, examine if there is strong evidence of structural change over time on determinants of locational choices of TDI in China.

A broader goal of this empirical study is to: (i) find the determinants of TDI in China at regional level; (ii) determine whether determinants in TDI in China at regional level have

changed over time; (iii) by examining labour quality variables to identify if technology transfer is significant from TDI into China; and (iv) to examine how effective the FDI policies from the Chinese government are in attracting TDI flows at regional level.

This study is important to both academics and policymakers for several reasons. With regards to objective (i) and (ii), note that TDI is crucial to China. Taiwanese and Hong Kong investors have been the major investors in China. TDI serves as a source of capital, stimulates domestic investment, creates employment, promotes the transfer of technology and enhances economic growth. Given the importance of TDI to China, it is surprising that very few papers have addressed this issue.

With regards to objectives (iii), the role of TDI as a source of technology transfer has become increasingly important to China but a major concern to the Taiwanese government. The reason for this is that Taiwanese economy has declined substantially with increasing unemployment, especially since the Taiwanese government relaxed the ban on direct investment into China.

With regards to objective (iv), it aims to explore the impact of FDI policies on TDI locational choices in China. The last two decades have witnessed an extensive growth in TDI flows into China. This has been accompanied by an increase in the competition amongst local governments to attract TDI, resulting in a rise in investment incentives offered by the Chinese government and the removal of restrictions on operations of foreign firms in some industrial zones. In this scenario, the question addressed by the study is: How effective are these selective government policies in attracting TDI flows to China?

1.3 Methodology

The study of Taiwanese investment behaviour is a study of the changing economy, and social and cultural relationships between China and Taiwan, which involves many parameters. China is a difficult country to study and its political, cultural and economic

fields are no exception. As the business and political environments in China and Taiwan are constantly changing, ready-made reports or journals, no matter how up-to-date, cannot always catch up with the change of the economy and politics in the two sides of Taiwan straits.

This section sets out the methodology used for this research. There are two methods available for exploring the locational choices of determinants of TDI into China. One is from questionnaire or case methods and the other is from empirical statistical techniques from official databases.

The main methodologies for TDI in China in the past have used either the case or questionnaire method. There are problems with both approaches. The case method is illuminating, but can not be generalizable. The questionnaire method may suffer from problems such as the weakness of the quality of the questionnaire, the low rate of return of questionnaire data etc (Khan et al., 2004). In particular, the Taiwanese government has regulated investments in China in some industries for years. It should be noted that Taiwanese investors often keep a very low profile regarding their investments in China because of the political tension between the two sides of the Strait, and might have easily choosen not to respond to the questionnaires (Bruton et al., 2004; Yang & Tu, 2004, Huang et al., 2004). Therefore, using the questionnaires or case studies is not a good method.

Although discrete-choice statistical techniques have been used with increasing regularity in demographic analyses, McFadden's conditional logit model is less well known and seldom used. Conditional logit models are appropriate when the choice among alternatives is modeled as a function of the characteristics of the alternatives, rather than (or in addition to) the characteristics of the individual making the choice (Hoffman et al., 1998). This feature of conditional logit makes it more appropriate for estimating behavioral models, where the explanatory variables may include attributes of the choice alternatives as well as characteristics of the individuals making the choices. Therefore, in this thesis, the conditional logit model is presented in measuring the locational choices of

TDI into China. Thus, one of the purposes of this study is to use provincial panel data from official statistical databases to test hypotheses within a well-specified econometric model. Using a new dataset and appropriate econometric techniques I hope to reach some definite conclusions regarding the explanation of the locational choices of the Taiwanese direct investment in China.

The review of important theoretical literature gives light to my research hypotheses, linking locational choices of TDI determinants in China to my analysis.

To test the hypotheses in this paper, I will use the provincial panel data which are compiled from various issues of the China Statistical Yearbook issued by the State Statistics Bureau of the PRC (SSB, 1997 to 2004) in China and the Statistics Monthly (*tongji yuebao*, 1997 to 2004) issued by the Investment Commission, the Ministry of Economic Affairs (MOEA) in Taiwan. In my sample, a region is either a province, or a centrally administered municipality, or an autonomous region. Because of data availability, I will confine my analysis over a seven-year period from 1997 to 2003.

In summary, the empirical analysis in this thesis is an attempt to examine the determinants of the locational choices of TDI in China for the period of 1997 to 2003, based on a conditional logit model framework.

1.4 Chapter Organization

This thesis will be divided into seven chapters. Chapter 1 starts with a brief historical review of the conflict and the economical relationship between China and Taiwan. Chapter 1 also provides an introduction on motivation, objectives, methodology, chapter organization as well as the contribution of this study.

Chapter 2 provides a literature review of traditional FDI theories, modern FDI theories, entry modes, FDI motives and the determinants of FDI in China at national or regional

levels. This chapter also explores the recent development of FDI in China, including features of China's FDI policy and the characteristics of FDI in China.

Chapter 3 presents a literature review of recent developments of TDI into China. This chapter analyses and provides an overview of Taiwan's economic relationship with China, its overall TDI status, the TDI status in China, the characteristics of TDI in China, the motives for TDI in China, how TDI in China impacts on Taiwan's domestic economy, its entry modes, and the determinants of TDI in China.

Chapter 4 explores how Taiwan' subcontracting system could impact on the TDI flows into China. The agglomeration effects of the Taiwanese industrial subcontracting system are also explored in this chapter

Chapter 5 examines the political backdrop of evolving cross-Strait economic relations. This allows us to observe the transformation that TDI has undergone since the beginning of Taiwan's political reform, and explore the impact of cross-Strait political issues on TDI development into China.

Based on the analysis in Chapter 2 to Chapter 5, Chapter 6 presents an econometric model using a conditional logit model analysis examining the determinants of locational choices of TDI in China and a summary of the principal findings.

Chapter 7 concludes the main findings of this study and presents topics for future study.

1.5 Contribution of This Study

This thesis contributes to the study of FDI on Taiwanese firms which have Mainland based ventures. Taiwan is a small country with political conflicts but cultural and ethnical similarities to Mainland China. Taiwan's political and domestic market conditions are very different from those of the multinationals from the USA or Japan that have dominated past research attention. There is a considerable literature on FDI flows into

China; however, the literature on TDI flows into China has been very limited. This thesis provides an overall picture of TDI in China. I will make an in-depth exploration into the investment motives, industries, and locations over a time span.

This study points out that an important motive for TDI in China is that Taiwanese industries are based on a 'subcontracting system' (*zhongwei tixi*), which consist of unique international production/distribution networks in East Asia, especially in the Chinese regions. Under the 'subcontracting system', the production/distribution networks consist of vertical production chains extended across Taiwan and China. Therefore, the motives of FDI from Taiwan into China are very different from the motives of FDI based on oligopolistic enterprises. As a result, TDI into China tends to be entirely made up of Taiwanese 'industrial migration' instead of the movement of individual firms due to the Taiwanese subcontracting system.

Efforts to attract investment from Taiwanese firms have become the focal point of competition between China and Taiwan. This competition in economy is maintained even when China and Taiwan are pursuing economic integration. This study uses TDI in China as an empirical study to identify the determinants, characteristics and impact of such investment. This study presents, analyzes, and synthesizes empirical study, suggesting that the insights might be useful for researchers studying investment and for policy makers in China and other transition economies.

Similar to Hou and Zhang's study (2001), my empirical results find that there is strong evidence of structural change on the determinants on locational choices of TDI into China over time, especially for infrastructure and labour cost. The factors behind the structural change include China's WTO entry and cultural links supported by FDI policy. The results also show the technology transfer from TDI into China has been significant for my sample period.

Chapter 2 FDI in China

2.0 Introduction

There has been an increasing amount of literature dealing with various dimensions of the characteristics, trends and determinants of FDI flow in China in the past two decades. The purpose of this chapter is to provide a review of the existing literature in FDI flows into China so as to provide an overview of FDI status in China in order to place my study into perspective.

Section 2.1 is a review of FDI theories. Section 2.2 is an overview of China's FDI polciy. Section 2.3 reviews the characteristics of FDI into China. Section 2.4 reviews the motives for FDI into China. Section 2.5 explores the recent study of the determinants of FDI in China. Section 2.6 explores the entry modes of FDI in China. Finally, section 2.7 concludes this chapter.

2.1 Traditional and Modern FDI Theory

FDI is an important constituent of the globalization efforts of the world economy (Dasgupta, 2004). Dunning (2002) suggests that it has become increasingly commonplace for firms to attain their competitive advantages from foreign-based activities, with FDI being the preferred way of organising such activities.

The theory of FDI answers the question as to why a firm would want to produce in a foreign location instead of exporting or entering into a licensing arrangement with local firms (Lim, 2001). Theories of FDI can be evaluated in terms of several different criteria (Pont, 2000): 1) whether each theory is logically consistent; 2) how well each theory predicts out-of-sample observations; and 3) how well each theory provides an explanation for the sharp changes in the country patterns of FDI. Dunning (2000a) also notes that paradigms and theories should be considered complementary analytical structures for

understanding, explaining and predicting the level, pattern and growth of MNE activity. Pont (2000) suggests that most theories of FDI, however, are under-determined and deal only partly with observed trends, which limits the possibility of explaining new trends, and limits the tested validity of each hypothesis.

This section reviews the definition of FDI, analyzes the traditional views of two major schools of thought concerning FDI, and modern theories of FDI. By understanding the concept of FDI theories, this chapter further explores the characteristics, motives, determinants of FDI in China, and entry modes of FDI in China.

2.1.1 Definition of FDI

There are major differences in the definition of FDI and the interpretation of FDI data in different countries. The purpose of this section is to review the overall definition of FDI and the definition of FDI in China.

(1) Overall Definition

Foreign investment is defined as "direct" when the investment gives rise to "foreign control" of domestic assets (Huang, 2003, p4). FDI is broadly defined as capital flows resulting from the behaviour of MNCs (Agiomirgianakis et al., 2003, p2). By definition, foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country (Hill, 1999). Another broad definition from Buckley and Brooke defines FDI as "a packaged transfer of capital, technology, management and other skills, which takes place internally within MNCs" (Buckley and Brooke, 1992). Historically, the MNC has been the main vehicle for FDI. The MNC is commonly defined as an enterprise which controls and manages assets in at least two countries (Helleiner, 1989).

The most common definition of FDI is related to the compilation Balance on Payment accounts and has been originally provided by IMF (1993) and subsequently endorsed by the OECD (1996). It is based on the ideas of lasting interest and influence on

management. The IMF[1] definition of FDI includes the following elements: as many as twelve different element-equity capital reinvested earning of foreign companies, inter-company debt transaction, short-term and long-term loans, financial leasing trade credits grants bonds, on-cash acquisition of equity, investment made by foreign venture capital investors, earning data of indirectly held FDI enterprises, control premium and non-competition fees (Arabi, 2005). The IMF definition is adopted by most countries and also by the United Nations Council for Trade and Development (UNCTAD) for reporting FDI data in its annual publication entitled 'World Investment Report' (Bajpai & Dasgupta, 2004).

IMF BPM5 (paragraph 359) defines FDI as:

'the category of international investment that reflects the objective of a resident entity in one economy ("direct investor") obtaining a lasting interest in an enterprise resident in another economy ("direct investment enterprise")'.

The two criteria incorporated in the notion of "lasting interest" are the existence of a long-term relationship between the direct investor and the enterprise and the significant degree of influence that gives the direct investor an effective voice in the management of the enterprise (Dasgupta, 2004; Bajpai & Dasgupta, 2004). However, the concept of lasting interest is not defined by IMF in terms of a specific time frame, and the more pertinent criterion adopted is that of the degree of ownership in an enterprise.

Also, as described in the glossary to Source OECD:

[1] FDI statistics are part of the balance of payments statistics collated and presented according to the guidelines stated in IMF Balance of Payments Manual, Fifth Edition, 1993 (BPM5) and "Benchmark Definition of Foreign Direct Investment" Organization for Economic Cooperation and Development (OECD) 'Third Edition, 1999 (Bajpai & Dasgupta, 2004).

"Lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated" (Eichengreen & Tong, 2005).

The IMF (p93) threshold is 10 per cent ownership of the ordinary shares or voting power or the equivalent for unincorporated enterprises. The OECD also recommends to follow the 10 per cent numerical guideline of ownership of ordinary shares or voting stock to determine the existence of a direct investment relationship. This is the empirical definition of FDI adopted by many countries to distinguish it from portfolio flows (WTO, 2002; Singh, 2002; Dasgupta, 2004).

There are clearly important differences between FDI and portfolio investment. As Dunning (1988, p15) points out, FDI involves issues of direct control as resources are transferred internally within firms rather than externally between independent firms. Dasgupta (2004) suggests that portfolio investments are also made by foreign investors but their main concern is the appreciation of the value of their capital and the return that it can generate regardless of any long-term relationship consideration or control of the enterprise. Conceptually, the main difference between the FDI and the portfolio investment is in the lasting interest expressed by the non-resident direct investor in the resident enterprise of the domestic economy. The lasting interest underlines a firm desire on the part of the non-resident investor to be associated with the long-term business activities of the resident enterprise by exerting significant influence on the management of the enterprise. With FDI, a foreign investor has greater risk compared to exporting or licensing, but has considerably more managerial control over the operation (Dasgupta, 2004).

In summary, FDI looks primarily at the cross-border investment transaction within MNCs and firms undertaking FDI do so with the aim of lasting interest and controlling the investment activity.

(2) A Definition of FDI in China

Wei et al. (2004) note in Chinese statistics that all investment from outside Mainland China is regarded as being "foreign". Under this definition, direct investment from Hong Kong, Macao and Taiwan is also recorded as FDI.

The Chinese system of reporting FDI is much more broad-based. China includes all the components prescribed by the IMF in its definition of FDI inflows. (Arabi, 2005; Dasgupta, 2004). Moreover, China also classifies imported equipment as FDI.

The previous section notes that FDI by definition is supposed to reflect a long-term commitment as it normally involves a stake of 10% or more in a host country enterprise, together with managerial control (Singh, 2002). For example, in the United States, the Department of Commerce defines inward FDI when a foreign investor's stake exceed 10 per cent. Under this definition, if a foreign firm acquires more than 10 per cent of a stake in a U.S. concern on the New York Stock Exchange, this capital inflow is credited to the FDI account in the balance of payments statistics, not to the portfolio account. In China, foreign equity capital inflows are classified as FDI only if they lead to a foreign equity stake at or above 25 per cent. Thus, the Chinese government set a more stringent threshold for FDI and for corporate controls (Huang, 2003).

On the other hand, China's FDI inflow numbers also include a substantial amount of 'round tripping' (Dasgupta, 2004[2]). Under IMF guidelines, FDI is defined when an investor based in one country acquires an asset in another country with the intent to manage that asset (IMF, 1993; IMF and OECD, 2000). This implies that FDI inflows into

[2] Existing studies acknowledge 'round-tripping' problem in China's FDI. See section 2.43 Statistical bias in the volume of FDI for round tripping.

a country by a foreign investor with an objective of long-term commitment. However, the rapidity of the in-and-out of money in Hong Kong contradicts the IMF guidelines (Bajpai & Dasgupta, 2004).

In summary, China adopted the IMF definition of FDI but set a more stringent threshold for defining FDI, although existing studies acknowledge China's FDI inflow numbers include a substantial amount of 'round tripping'.

2.1.2 The Traditional View

There are two major schools of thought concerning FDI. The conventional school, pioneered by Hymer (1960) and Caves (1974), suggests that FDI is undertaken only by firms that posses some intangible asset.

The other school of thought (Vernon, 1966; Kojima 1973), states that FDI can be seen as a defensive action undertaken by firms to protect their export market which is either damaged by unfavourable development in the macroeconomic conditions, such as wage increases and/or currency appreciation, at home (Kojima, 1973) or threatened by competitors in the local market (Vernon, 1966). 'Defensive' FDI is often made in low-wage countries to reduce the production costs, and as a result, to sustain international competitiveness (Pont, 2000). Pont (2000) suggests that if both types of FDI exist in the real world, it is empirically difficult to distinguish one from the other because the actual FDI may be undertaken for a mixture of reasons including market exploitation and labour-seeking motives.

2.1.3 Modern FDI Theory

Extensive theoretical and empirical research has focused on various explanations of a firm's FDI. The theories of FDI have traditionally emphasised market imperfection (Hymer, 1960; Kindleberger, 1969), industrial organization (Caves, 1971), the product life-cycle (Vernon, 1966, 1971), internalisation theory (Buckley and Casson, 1976), and Dunning's (1988) eclectic paradigm.

(1) Market Imperfection Theory

Hymer's research (written in 1960 and published in 1976) was regarded as the first modern industrial organizational theory of FDI (Yamin 1990; Pont, 2000; Jiang 2003). Hymer (1976) was the first scholar to theorize that firms faced costs of doing business abroad (Eden & Miller, 2001). Because of the costs involved, Hymer (1976) argued that the MNE needed advantages if it was to go abroad and be successful.

Hymer (1976) states that due to structural imperfections, some firms enjoy advantages in comparison with competitors, such as patents, superior technology, etc. A firm may possess an advantage over its competitors in a particular industry, and the possession of the advantage may cause it to have extensive international operations of one kind or another (Yamin, 1990). Pont (2000) suggests that under Hymer's market imperfection theory, FDI had to be seen in the context of the search for control by oligopolistic enterprises[3]. Hymer also indicated the importance of the advantage theory of direct, horizontal investments by MNEs.

Hymer's contribution to FDI therories are: 1) the possession of advantage can explain the need to control the activities of firms in other countries; 2) he was the first to directly pose the alternatives of licensing technology and of direct investment; 3) to argue the different reasons why special advantages may not be cashed for the same returns through licensing arrangements and may thus require direct investment abroad; and 4) by shedding light on the transaction costs approach by arguing that horizontal investment can be caused by imperferctions in markets for intangibles (Hymer, 1968; Yamin, 1990; Pont, 2000)

[3] An oligopoly is made up of multinational corporations that have choosen specific product or service categories to dominate. In each category, over time, only two to four major players prosper. Starting a new company in that market segment is difficult, and the few that do succeed are often gobbled up or run out of business by the oligopolies.

(2) Theories of Industrial Organization

Kindleberger (1969) argues that the ownership advantages from Hymer's research reveals some kind of structural failure (Pont, 2000). The theory of industrial organization is based on models of 'oligopolistic competition' and stresses that the advantages that enable a firm to attain a large size in its domestic market facilitates the expansion of its foreign subsidiaries (Caves, 1971).

This theory is concerned with five features: 1) Hymer's research reveals some kind of structural failure; 2) the critical ownership advantage is 'product differentiation'; 3) ownership advantages may vary according to whether FDI is carried out by horizontally or vertically integrated MNCs; 4) extending the direct operations of the firm and bridging under common ownership, and controlling the activities conducted by intermediate markets that link the firm to customers; and 5) firms will gain in creating their own internal market such that transactions can be carried out at a lower cost within the firm (Kindleberger, 1969; Caves, 1971; Buckley and Brooke, 1992; Pont, 2000)

(3) Product Life-Cycle Theory

Vernon (1966, 1979) has contributed to the literature of modern FDI theories with his product life-cycle theory (PLC theory). This PLC theory addresses the following features: 1) the significant ownership advantage is technology; 2) FDI occurs when in the maturity phase the innovator shifts products to developing countries due to lower factor cost advantages; and 3) it develops a concept of re-localization production activities (Vernon, 1966, 1971, 1979).

In the PLC theory, the significant ownership advantage is technology. Products have a finite economic life and go through four phases in terms of introduction, growth, maturity, and decline. Introduction is the stage where a product is conceptualized and first brought to market. The growth phase occurs when a product has survived its introduction and is beginning to be noticed in the marketplace. At the maturity stage, sales growth has started to slow and is approaching the point where the inevitable decline will begin.

Vernon (1966, 1971) states that FDI occurs when in the maturity phase the innovator shifts products to developing countries due to lower factor cost advantages, which is called product life-cycle theory. Vernon's (1966) product life-cycle hypothesis introduced a new reason why a firm would invest abroad rather than export. Vernon's main contribution is a development view on re-localization of production activities (Melin, 1992).

Pont (2000) suggests that the 'implicit assumption' of the PLC theory of FDI is that the firms which developed the products in their domestic markets would acquire the manufacturing plants in the countries identified with abundant unskilled labour, rather then sell or license their technology to host-country competitors. Vernon (1979), however, recognized that its validity as a model of the evolution of the MNC was challenged by the changes in American MNCs in the latter part of the 1970s. The fact is that in the latter part of the 1970s many of America's leading MNCs had well-established production networks around the world, and were increasingly likely to introduce new products simultaneously into several markets, rather than beginning at home and rolling out the product internationally over time (Vernon, 1979).

(4) Internalisation Theory

Buckley and Casson (1976) emphasized the ability to innovate as the basis for internalisation of cross-border economic activity. Buckley and Casson (1976) developed their theory from three simple postulates (Henisz, 2003): 1) Firms maximize profits in a world of imperfect markets. 2) When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets. This involves bringing under common ownership and control the activities that are linked by the market. And 3) Internalisation of markets across national boundaries generates MNEs (Buckley and Casson, 1976, p33).

Internalisation theory (Buckley and Casson, 1976; Rugman, 1979, 1980) is very closely related to transaction cost theory (Rugman, 1981). Internalisation through FDI allows

firms to minimise transactions costs. Rugman (1986) argues that internalisation theory is the transaction cost theory of multinationals. Casson (1982) suggests that the major significant factor of internalisation theory for MNEs is not that it explains the existence of the firm, but that it explains the importance of vertical integration for multi-plant operations.

The internalisation theory is largely concerned with identifying the situations in which the markets for intermediate products are likely to be internalised, and hence those in which firms own and control value-adding activities outside their national boundaries (Pont 2000). However, transaction cost economies considers the growth of any company regardless of the operating domain (Madhok, 1998).

(5) The Eclectic Theory of International Production

Dunning (1973, 1977, 1980, and 1988) extended the internalisation theory by including location-specific factors and explaining how these factors influence the nature and direction of FDI (Etemad, 200). Dunning's (1977) eclectic paradigm has been one of the leading frameworks for explaining multinational activity over the past two decades. According to Dunning's (1977) framework, the international production is determined by three sets of advantages: ownership, location and internalisation, which will be explored as follows.

(i) Ownership-specific Advantages (Hymer, 1960)

The concept of the ownership-specific advantage (O) is from Hymer's study (1960), which states that core competencies give competitive advantage over firms already serving foreign markets. These O advartages largely take in the form of the privileged possession of intangible assets and cross-border value-added activities. These O advantages are assumed to increase the wealth-creating capacity of a firm, and hence the value of its assets (Itaki, 1991) in order to offset the disadvantage of not being a local firm (Madhok and Phene, 2001)

(ii) Location-specific Advantages

The location-specific advantages (L) arise from differences in factor endowment, transport costs and distance, artificial barriers, and infrastructure and incentives existent at different foreign locations. Some of the location-specific advantages include natural resources (e.g. oil & other mineral resources), inputs (e.g. inexpensive but highly skilled labour) and services originating from outside MNEs' home country.

Dunning's L advantages refer to advantages accruing to an MNE due to the use of resource endowments or assets tied to a particular foreign location such as mines (Etemad, 2002). To benefit fully from the potential created by the O advantages, there must be some need to combine them with some L advantages of host countries' firms (Madhok and Phene, 2001). Etemad (2002) also asserts that when O advantages, such as technology, patents, trademarks and management know-how, are combined with the L advantages, a venture's viability and profitability can be further enhanced.

(iii) Internalisation Advantages

Ethier (1986) states that the study of FDI must be foremost a study of internalisation-decision to keep activities within a firm. To complete the triangle, given the O advantage, there must be some benefit to undertaking the relevant set of activities internally (the internalisation or I advantage) within the firm rather than through more arm-length contractual mechanisms like licensing, or market mechanisms such as exports (Madhok and Phene, 2001). O advantage, therefore, results from internalising foreign operations through control over supplies or over market outlets. The importance of I advantage is because it can magnify any advantage and lead to a differentially higher real and potential market power as compared to others (Etemad, 2002)

Therefore, internalisation advantage arises when a firm has a reason to exploit its ownership advantage internally, rather then sell its product to a foreign firm or incur costs of monitoring licenses (Rothmuller, 2003).

(iv) Criticism

The eclectic paradigm has become the dominant theoretical basis in the study of international business, MNEs and internationalization since 1980. However, recent trends in international business pose a challenge to the explanatory power of the paradigm (Madhok and Phene 2001; Etemad, 2002; Narula and Cantwell, 2003; Forssbæck, and Oxelheim, 2004).

Dunning (1981) explains that although the eclectic model is a general theory in so far as it provides an analytical framework for explaining all forms of such production, this is not to assert that all types are to be explained by the same OLI characteristics. Dunning (2000a, p12) notes the eclectic paradigm of international production remains a powerful and robust paradigm (*vis à vis*) other paradigms, but as the motives and determinants of MNEs are increasingly widened to embrace social *et alv*considerations, it may need further refinement and/or reformulation in the early 2000s. Madhok and Phene (2001) argue that the OLI framework is not adequate to deal with this question of performance differences across firms with the related issues. Etemad (2002) also argues that Dunning does not clearly specify their interdependencies, their inter-linkages, and the conditions under which these three advantages combine to support FDI decisions or the circumstances under which these advantages may not combine synergistically.

In summary, this section has reviewed the modern FDI theories. Among all modern FDI theories, Dunning's OLI paradigm is now the theoretical tool kit which is most commonly used to conduct empirical studies aimed at gaining a better understanding of FDI determinants, although it leaves much room for disagreement and further analysis concerning the OLI advantages behind FDI (Helleiner, 1989) and has already faced several challenges recently.

2.2 China's FDI Policy

Most studies (Wei, 1993; Wei, 1995a; Shan et al., 1999; Dees, 1998; Fung et al., 2002; Taube and Ögütçü, 2002; Zhang et al., 2005) acknowledge that FDI has been important

in explaining China's economic growth. This section provides an overview of the role of FDI on China's economic growth. By understanding the role of FDI on China's economic growth, this section further reviews the phases of FDI regime in China and explores the recent literature devoted to the features of China's FDI policy.

2.2.1 FDI & China's Economic Growth

Since 1978 when China adopted an open door policy as a strategy of economic reform and moved towards a further integration into the world economy, its economic growth has impressed the world. China now has the world's second largest GDP. Some scholars (e.g. Wei, 1995a; Englesberg, 1995) suggest that the reform launched in 1979 qualifies as a megapolicy. Wei (1995a) states that the Chinese economic reforms pulled the country from the verge of economic collapse and put it well on the road to economic development. With a double-digit growth rate for the last decade, China now is one of the fastest growing economies in the world.

From a closed economy at the end of 1970s, by the mid-1990s China had become the 11th largest trading country. Its openness (measured by total foreign trade as a percentage of GDP) increased from 17% in 1978 to about 40% in the mid-1990s. FDI also surged; in 1993, China has become the second hottest investment destination country, second only to the US (Galbraith and Lu, 2000). In 2003, China overtook the US as a destination for FDI and, with inflows of $53 billion, became the largest FDI recipient in the world (excluding Luxembourg) (World Investment Report, 2004, UNCTAD)[4]. The lead position of China among the destinations of global FDI inflows has also been confirmed by the 2002 A.T. Kearney FDI Confidence Index Survey (Dasgupta, 2004).

Since the Open Door Policy was launched at the end of the 1970s, China has had a high and sustained growth rate for the last twenty years. China's real GNP grew at a 10 per

[4] See also UNCTAD/PRESS/IN/2005/007 07/03/05

http://www.unctad.org/Templates/webflyer.asp?docid=5795&intItemID=1634&lang=1

cent annual rate in the 1980s, up from an average 6.5 per cent in the 1970s. In the coastal areas, the average growth rate is about 12 per cent. Growth on GNP was fastest toward the end of the 1980s until October 1988. Inflationary pressures forced the Chinese government to launch an austerity program in October 1988. An impressive rebound was in the making, with 12.8 per cent growth for China in 1992, which marks the highest rate in the world (Plummer and Montes, 1995).

China's real distinctions with other host countries are threefold: its huge country size, its massive overseas Chinese population, and its strong government (Zhang, 2002). The combination of these distinctions, and the FDI boom, makes a host of interesting characteristics regarding China's FDI. In fact, China is now the largest recipient of FDI in the world.

It is widely believed that FDI has been important in explaining China's economic growth (e.g. Wei, 1993; Wei, 1995a; Shan et al., 1999; Dees, 1998; Fung et al., 2002; Taube and Ögütçü, 2002; Zhang et al., 2005). Shan et al. (1999) assert that FDI into China is a cause for its industrial growth and economic development, which in turn causes the inflow of new FDI into China. Taube and Ögütçü (2002) also suggest that the patterns of China's FDI-inflows show a marked similarity to the patterns of regional development, raising suspicions of some potential causal relationship between regional development and the attraction of FDI. The empirical results from Lheem and Guo (2004) also confirm main findings of earlier studies on the links between FDI and economic growth in China, but disapprove the impact of human capital, historical, and geographical conditions on FDI distributions in the regions during the research period.

FDI has also contributed to the rapid growth of China's merchandise exports, at an annual rate of 15 per cent from 1989 to 2001. In 1989, foreign affiliates accounted for less than 9 per cent of Chinese exports; by 2002 they provided half. In some high-tech industries in 2000, the share of foreign affiliates in exports was over 90 per cent, for example, electronics circuits (91 per cent) and mobile phones (96 per cent) (World Investment Report, 2003, UNCTAD). Another interesting study by Liu et al. (2001)

indicates a positive cycle of development for China: the growth of China's imports causes the growth in inward FDI from a home country/region, which, in turn, causes the growth of exports from China to the home country/region. As a result, the growth of exports causes the growth of imports.

However, some economists (e.g. Young, 1997; Branstetter & Feenstra, 1999; Fung et al., 2005) have argued about the sustainability of China's current rates of GDP, export growth and FDI inflows. Young (1997) has argued that China's high trade/GDP ratio is a sign of intra-national trade barriers rather than international economic openness (Young, 1997; Branstetter & Feenstra, 1999). Empirical results from Branstetter and Feenstra (1999) suggest China may find it politically difficult to follow through with liberalizing its trade and investment regimes, such as under its WTO accession proposal. Another recent study by Fung et al. (2005) also points out the surge of FDI inflow to the coastal regions has contributed to an increased inter-regional economic disparity within China. This study suggests that such inequalities can create social and political instability and ultimately can cause damage to the economy.

Given this controversy over the impact of FDI on the economic development of China, an analysis of the features of China's FDI policy is worthy of attention.

Table 2.1 Annual GDP in China, 1978-2003 (unit: 100 million RMB)

Yes	GDP
1978	3624.1
1979	4038.2
1980	4517.8
1981	4860.3
1982	5301.8
1983	5957.4
1984	7206.7
1985	8989.1
1986	10201.4
1987	11954.5

1988	14922.3
1989	16909.2
1990	18598.4
1991	21662.5
1992	26651.9
1993	34560.5
1994	46670.0
1995	57494.9
1996	66850.5
1997	73142.7
1998	76967.2
1999	80579.3
2000	88254.0
2001	95727.8
2002	103935.3
2003	116603.2

Source: State Statistical Bureau, China Statistical Yearbook, 2004. (http://www.stats.gov.cn)

2.2.2 Phases of FDI regime in China

Exisitng studies classified development of China's FDI into different phases. Huang (2003) classified development of China's FDI into four phases: Permitting FDI (1979-1985), Selectively encouraging FDI (1986-1991), Substantial FDI liberalization (1992-1996), Streamlining FDI approvals and WTO (1997-2000). Another recent study from Wei (2003) suggests that four stages in the development path of inward FDI can be discerned: the experimental stage (1979-1983), the growth stage (1984-1991), the peak stage (1992-1994), and the adjustment stage (1995 onwards).

China's official classifications (Li and Xu, 1994; Yang, 1997; Yang, 2003; See Table 2.2) of FDI regime in China are: Experimental Stage (1979-1983), Primary Development Stage (1984-1986), Adjustment and Consolidation Stage (1987-1991), and High

Development Stage (1992-present). The features of FDI regime in China will be explored in the next section.

Table 2.2 Phases of FDI Regime in China.

Period	Major event
1979-1983	Experimental Stage
1984-1986	Primary Development Stage
1987-1991	Adjustment and Consolidation Stage
1992-present	High Development Stage

(Source: Li and Xu, 1994; Yang, 1997; Yang, 2003)

2.2.3 Features of China's FDI Policy

China has achieved drastic economic growth over 27 years since the reform and Open Door Policy initiative launched by Deng Xiaoping in 1978. Many studies (e.g. Wei, 1993; Bucknall, 1989; Dees, 1998; OECD, 2000; Galbraith and Lu, 2000; Fung et al., 2002; Tseng and Zebregs, 2002, Zhang et al., 2005; Wan, 2005; Fung et al., 2005) agree that China's high economic growth has been supported by the Open Door Policy to introduce foreign investment. The Open Door Policy, therefore, has played a very important role in the evolution of China's FDI policy.

The major features of China's FDI policy are: geographic opening, a selective FDI policy, special treatment for overseas Chinese creating SEZs, strong leaderships in promoting FDI from export promotion to an open domestic market.

(1) Geographic Opening

The geographic opening began in July 1979, when China granted the provinces of Guangdong (bordering Hong Kong) and Fujian (across the strait from Taiwan) preferential policy flexibility (see Table 2.3). The Chinese government established 'special economic zones' (SEZs), first along the coastline and then along the Yantze

River (Hayashi, 2003). In May 1980, the Shengzhen, Zhuhai, Shantou and Xiamen Special Economic Zones were created. In February 1982, the Yangtze River Delta, Zhu River Delta and three other regions in Fujian, Liaonin, and Shandong were opened. These four SEZs were established in which foreign firms were offered preferential tax and administrative treatment, and given an unusually free hand in their operations. In particular, these zones charged a reduced tax of 15% on business income of foreign affiliated firms (as compared to 33% for domestic firms), but these taxes were not levied during the first two years of operation and only charged at one-half of the full rate in the third through to the fifth years (Branstetter & Feenstra, 1999). For the first time in modern Chinese history, wholly foreign owned enterprises were permitted in the SEZs (Person, 1994; Hayashi, 2003).

Other areas which are in some ways clones of SEZs, have also been allowed, and such zone clones are becoming increasingly common (Bucknall, 1989). In 1984, fourteen additional coastal cities known as "open coastal cities," were granted similar exemptions from taxes and administrative procedures in a bid to attract FDI. These cities levied a tax rate of 24% on foreign affiliated firms, and were granted local authority to approve foreign investment for projects under $30 million (now $50 million). The entire island of Hainan was declared a special economic zone in 1988 (Branstetter & Feenstra, 1999). In 1988, Hainan Island Province became the largest SEZ. During the new round of reform in 1990s, first, Pudong of Shanghai was opened. In 1991, four border cities on the China-Russia frontier were opened. In August 1992, 15 more hinterland cities were opened, and since that time, major cities all over China have followed suit. (Galbraith and Lu, 2000).

Table 2.3 FDI-Related Institutional Changes

Phases	Accessible Locations	Industry Orientation	Entry Modes
1979 – 1983	4 SEZs		EJVs
1984 – 1988	14 open coastal cities, Yangtze River Delta, Pearl River Delta, Golden Triangle Areas, Hainan island, Liaodong and Shandong peninsulas	Provisions for the encouragement of foreign investment with additional incentives for export, import	WFOEs, CJVs

		substitution and high-tech project	
1989 – 1991	Pudong New Area in Shanghai		
1992 – 1994	21 cities along the Yangtze River and in the Northeast	Open retailing sector	Umbrella companies
1995 – 1998		Orientation directory of industries Open banking sector	B share trading BOT
1999 – 2000	Inland provinces by "Go West" strategy		M&As
2001 onwards		Other service sectors	

Source: Zhang et al., 2005

(2) Selective FDI Policy

China's FDI policy is characterized by a very selective policy (Branstetter & Feenstra, 1999; Hugonnier, 2001; Hou ; 2002; Hayashi, 2003). Hugonnier (2001) suggests that it is important that policies for attracting FDI be selective in order to reduce the volatility of outside investment and increase its multiplying effect on regional economic activity.

Hou suggests (2002) that while permitting entry of foreign firms, the law did not create a clear legal framework to facilitate the complicated issues involved in FDI. Hayashi (2003) suggests that foreign enterprises in SEZs were subject to rather tight restrictions during 1979 to 1991. Zhang et al. (2005) describe how FDI was attracted as "experimental" reform and confined to certain regions in the initial years. Hou (2002) also asserts that China's first steps were careful and cautious. For example, they were permitted to operate only within the geographical area designated as SEZs. Also, foreign exchange had been under tight control in the early years of China's FDI policy as foreign investors were not allowed to transfer the foreign exchanges they earned to the source country. As a result, in the early stages of the Open Door Policy, problems like the lack of currency convertibility caused many would-be-investor to hesitate (Hou, 2002)

As is shown in Table 2.4, FDI into China gradually increased in volume from 1979 to 1991. In terms of inward FDI flows, foreign investors appeared on a modest scale in China after the passage of the "Law on Joint Venture" in 1979. By the end of 1989, the total inflows reached about US $19 billion. FDI, including equity and contractual joint ventures (EJVs and CJVs), oil exploration and, wholly foreign-owned enterprises (WOEs), have accounted for over 80 per cent of these inflows, while other investments such as leasing, compensation trade, and processing and assembling accounted for the remaining 20 per cent (Branstetter & Feenstra, 1999).

Since 1992, the Chinese government changed from limiting foreign investment to requiring Chinese companies to allow foreign investors to acquire significant positions in existing companies, mostly retail- and consumer-goods producers (Pearson, 1994). Restrictions on external debt and equity finance were relaxed, and controls on foreign trade were reduced. Provincial and local governments were allowed considerable freedom in regulating the joint ventures that were established within their jurisdictions (Branstetter & Feenstra, 1999).

Table 2.4 FDI Inflows into China, 1983-2002 (Unit: $100 million)

	Contracted FDI		Realized FDI	
Year	Amount	Growth Rate	Amount	Growth Rate
1979-1982	6,010	-	1,166	-
1983	1,732	-	636	-
1984	2,651	53.10%	1,258	97.80%
1985	5,932	123.80%	1,661	32%
1986	2,834	-52.20%	1,874	12.8%
1987	3,709	30.90%	2,314	23.5%
1988	5,297	42.8%	3,194	38%
1989	5,600	5.7%	3,392	6.2%
1990	6,596	17.8%	3,487	2.8%
1991	11,977	81.6%	4,366	25.2%
1992	58,124	385.3%	11,007	152.10%

1993	111,436	91.7%	27,515	150.0%
1994	82,680	-25.8%	33,767	22.7%
1995	91,282	10.4%	37,521	11.1%
1996	73,277	-19.7%	41,725	11.2%
1997	51,004	-30.4%	45,257	8.5%
1998	52,102	2.2%	45,463	0.5%
1999	41,233	-20.9%	40,319	-11.3%
2000	62,380	51.3%	40,715	1.0%
2001	69,195	10.9%	46,878	15.1%
2002	82,768	19.6%	52,743	12.5%
1979-2002	827,809		446,258	

Source: State Statistical Bureau, China Statistical Yearbook, 2003; Fung et al., 2003

(3) Special Treatment for Overseas Chinese

A substantial portion of the FDI to China comes from overseas Chinese businessmen who are relocating manufacturing operations to Mainland China (Bajpai & Dasgupta, 2004; Dasgupta, 2004). This situation results from the fact that special incentives have been offered to investors from Taiwan, Singapore, Hong Kong and Macao—a policy that has lead to a heavy concentration of FDI in southern coastal China, to the detriment of the other provinces (Hugonnier, 2001).

China has two strong neighbours in Hong Kong and Taiwan. Hong Kong and Taiwan had begun to upgrade from the manufacturing to the services sector just when China liberalized its economy in 1979. China offer strong FDI incentives to overseas Chinese, such as SEZs, tax holidays, hassle-free bureaucratic clearances etc. that encouraged them to relocate their manufacturing industries in their entirety to the coastal provinces, mostly Guangdong and Fujian, in China. Over two thirds of China's FDI inflows were consistently made by the overseas Chinese in the 1990s and less than one-third from non-Chinese sources (Bajpai & Dasgupta, 2004; Dasgupta, 2004).

Barabantseva (2005) suggests that the establishment of the SEZs and open cities in the Eastern coastal area of China, characterised by the high concentration of *qiaoxiang,* served the purpose of attracting FDI from overseas Chinese. This economic arrangement was supplemented by 1983 legislation and 1985 State Council provisions which granted special privileges to overseas Chinese citizens (including those in Hong Kong and Taiwan) and ethnic Chinese wanting to invest in China. These policy regulations were coined as a 'call back' policy (Sie, 1997) and were formulated around the overall objective of the economic development of China (Barabantseva, 2005).

To further encourage FDI from overseas Chinese, the Chinese government, through a decree passed on 18th August 1990, provided special rules and regulations to encourage FDI from its overseas Chinese population. The Chinese government has pursued an active policy to attract investments by the non-resident Chinese. This shows that China has maintained its links with the Chinese abroad, both culturally and economically (Dasgupta, 2004).

(4) Strong Leadership in Promoting FDI

Strong leadership in promoting FDI is one of the important features of China's FDI policy. Although there had been some restrictions on foreign enterprises during the first phase of the Open Door Policy, all these new policies or regulations show the notable attitude changes towards foreigners (Bucknall, 1989). Zhang et al. (2005) described this institutional change as 'deviation from the path' in 1978 when the economic reform and open-door policy was initiated. Historically, China has experienced different phases in which they treated foreign investment differently, from indifferent to reluctant to hostile and to positive (Zhang et al., 2005). To some Chinese people, they bear a strong comparison to the foreign concession areas of the Qing dynasty of the nineteenth century.[5] The issue is sensitive and therefore a series of the official press releases have

[5]According to personal interviews from 1995 to 1998, some Chinese still show the hostility to foreign people because of the past history of the Qing Dynasty's foreign problems. However, the Chinese government has tried to ease the unrest. The new policies or rules towards the foreign investments have

pointed out the important differences between the SEZs and the old foreign concessions or settlement, in order to calm unease and opposition (Bucknall, 1989).

The Chinese political leadership imposed a vision for the path of growth and development of the country. Nevertheless, China had to overcome the obstacles to FDI rooted in its history and ideology. The political leadership did this by limiting the opening to a few localities initially, but even then, a great deal of autonomy in economic decisions was given to local governments in terms of allowing the market-based economy to develop alongside a centrally planned system. (Tseng and Zebregs, 2002). This shows a great deal of political commitment for FDI from the Chinese government. Therefore, the historical attitudes show that the institutional change since 1978 is a 'deviation from the path' from the previous stage, but not necessarily a break from the long historical perspective. This change is historically of significance, not only to China and all Chinese people, but also to the world and foreign investors (Zhang et al., 2005).

Many scholars (e.g. Burles, 2000; Yang, 2003; Eichengreen and Tong, 2005; Zhang et al., 2005) suggest that Deng Xiaoping's Southern Journey played an important role in China's FDI policy. Deng Xiaoping's Southern Journey's two major contributions towards China's FDI policy were (Eichengreen and Tong, 2005; Zhang et al., 2005): 1) setting the scene for China's move away from the uneven regional priority toward the nation-wide implementation of open policies for FDI (OECD, 2000) and 2) re-affirming the economic reform and open policies.

Eichengreen and Tong (2005) assert that although China first opened its doors to FDI in 1979, interest on the part of foreign investors was stimulated when Deng Xiaoping reaffirmed China's commitment to market-friendly reforms and opening the economy during a tour of the southern provinces in 1992. Another study by Zhang et al. (2005) also agrees that Deng Xiaoping's 1992 "Southern Journey" re-affirmed the economic reform and open policies. After the Southern Journey, China adopted a new approach,

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been changed in terms of encouraging the foreign investment. So, it shows a notable attitude change for some Chinese.

which turned away from special regimes toward a more nation-wide implementation of open policies for FDI. Moreover, the Chinese government issued a series of new policies and regulations to encourage FDI inflows. The results were remarkable. The economy also grew fast, with an average GDP increase of around 8 per cent from 1992 to 2000, and the supply of basic production material improved considerably (Yang, 2003). Since 1992 the inflows of FDI into China have accelerated and reached a peak level of US$45,463 million in 1998 (OECD, 2000; See Table 2.4).

Table 2.5 Summarizes the Evolution of China's Main FDI Policy.

1979	The "Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign investment" ("Law of Sino-Foreign Joint Ventures" was adopted, granting foreign investment a legal status in China.)
1980	Four special economic zones (SEZs) were established in the southeast coast to attract foreign capital and advanced technology. One of them is Xiamen in Fujian, which was not only intended to attract TDI but also to facilitate the eventual reunification of China.
1983	Regulation for the implementation of the law of the People's Republic of China on Chinese-foreign Equity Joint Ventures
1986	• Wholly Owned Subsidiaries (WOS) Law • New provisions (called "Twenty-two Provisions on the Encouragement of Foreign Investment") were established. The new incentives included: reducing fees for labour and land use; establishing a limited foreign currency market for joint ventures; and extending the maximum duration of a joint-venture agreement beyond 50 years. • Constitutional Status of Foreign Invested Enterprises in Chinese Civil Law
1987	Interim Provisions on Guiding FDI
1988	• Delegation on Approval of selected FDI Projects to more Local Governments • Laws of Cooperative Joint Ventures
1990	• Amendments to the 1979 "Joint-Ventures Law" were passed, greatly improving the investment climate in China. The stipulation that the chairman of the board of a joint venture should be appointed by Chinese investors, for example, was abolished. Also significant was the provision of protection from nationalization. • Revision of Equity Joint Venture Law (1990) • Rules for Implementation of WOS Law • The concept of SEZs was extended to the Shanghai Pudong New Development Area, which is about the size of Singapore.

1991	Income Tax Law and its Rules for Implementation
1992	Deng Xiaoping visited China's southern coastal areas and SEZs. Trade Union Law
1993	• Company Law • Provisions Regulations of Value-added Tax, Consumption Tax, Business Tax and Enterprise Income Tax
1994	• Law on Certified Public Accountants • Law of the People's Republic of China on Protection of Taiwan Compatriots' Investment • Provisions for Foreign Exchange Controls
1995	• Insurance Law • Law of Commercial Bank • Detailed rules for implementation of Cooperative Joint Venture Law • Provisions on Guiding Foreign Investment Direction • Petitioned the WTO in November of 1995.
1996	Further delegation for approving FDI to local government
1997	• Shenzhen (the most important SEZ) allowed foreign-invested enterprises with advanced technology to sell 10% of their products on the domestic market. • Provisions on Guiding Foreign Investment Direction • Provisions for Foreign Exchange Controls
1999	Constitutional amendment: private enterprises acknowledged
2000	Industrial Catalogue for Foreign Investment in the Central and Western Regions
2001	• Revision of Equity Joint Venture Law • Revision of regulation for the implementation of the law of the People's Republic of China on Chinese-foreign Equity Joint Ventures • Rules for Implementation of WOS Law
2002	• China became a member of the WTO. China promised to open its domestic markets, which plays an important role in China's FDI policy. • Provisions on Guiding Foreign Investment Direction.

Source: OECD, 2000; Hou, 2002; Chen and Song, 2003; Zhang et al., 2005

(5) From Export Promotion to Open Domestic Market

A major regulatory change in FDI came in 1986, with the implementation of the "Twenty-Two Regulations" (Branstetter & Feenstra, 1999; Hou, 2002; Breslin, 2003). Foreign invested enterprises were made eligible for reduced business income tax rates regardless of location, and were given increased managerial autonomy. Tight controls on the remittance of profit in foreign currencies were lifted. It also extended the joint venture contracts beyond the original 50 year limit, and created a legal basis for wholly foreign owned enterprises rather that investors having to sign a joint venture with a Chinese partner (Breslin, 2003).

In addition, the Twenty-Two Regulations designated two categories of foreign investments as being eligible for additional special benefits – "export oriented" projects and "technologically advanced" projects. "Export oriented" is defined as projects exporting 50% or more of their production value. "Technologically advanced" is defined as projects which upgrade domestic production capacity through the use of 'advanced' technology (Branstetter & Feenstra, 1999). This move considerably increased the attraction of investing in China to produce exports for other markets. While foreign invested enterprises only accounted for two per cent of exports and six per cent of imports before 1986, the figure increased to 48 per cent and 52 per cent respectively by 2000 (Breslin, 2003).

The reason behind this major policy implementation is China's petition to be reinstated into GATT[6]. The main theme was the use of preferential tax policies to encourage FDI and attract export-oriented ventures, with the exception of offshore oil exploration and the real estate sector (hotels and other tourism-related projects in particular (Hou, 2002). These changes represented a major liberalization which applied throughout China (Branstetter & Feenstra, 1999).

[6]General Agreement on Tariffs and Trade (usually abbreviated GATT) functions as the foundation of the WTO trading system.

Under the Twenty-Two Regulations, additional tax benefits were offered to export-oriented joint ventures and those employing advanced technology (Fung, Iizaka, and Tong, 2002). However, due to the commitment to WTO, a gradually opening of the domestic market has also played an important role in China's FDI policy. Hou (2002) suggests that this "export promotion" FDI regime persisted till 1992 although export industries still play an important role in China's FDI. It was at this point that China exhibited a paradigm shift and began to gradually open certain sectors of its domestic market to MNEs, including services such as telecommunication, transportation, insurance and banking.

On the trade side, the Chinese government lowered important tariff rate throughout the entire period of the Open Door Policy. After China was acceded to the WTO, the Chinese government promised to lower tariffs even further to meet the accession conditions (Hayashi, 2003). Moreover, China now allows foreign investors to buy majority stakes in previously barred enterprises. Its privatization plans include China Power, China Construction Bank, Air China and Semiconductor Manufacturing International (World Investment Report, 2004, UNCTAD). This shows another major change in China's FDI policy.

2.3 Characteristics of FDI in China

After exploring the features of China's FDI policy, this section explores the characteristics of inward FDI in China. The general characteristics and trends of FDI in China have received extensive attention from scholars (e.g. Chen, 1997; Cheng and Kwan, 2000a, 2000b; Coughlin and Segev, 2000a; Lemoine, 2000; Wei, 2003; Wei and Liu, 2004). Among all the researches, Wei (2003) has made the most comprehensive research on the characteristics of inward FDI in China. The characteristics of inward FDI in China include (scholars (e.g. Chen, 1997; Cheng and Kwan, 2000a, 2000b; Coughlin and Segev, 2000a; Lemoine, 2000; Wei, 2003): the uneven development of FDI, the statistical bias in the volume of FDI, the statistical bias of FDI by nationality of source countries, the uneven sectoral distribution of FDI and regional bias.

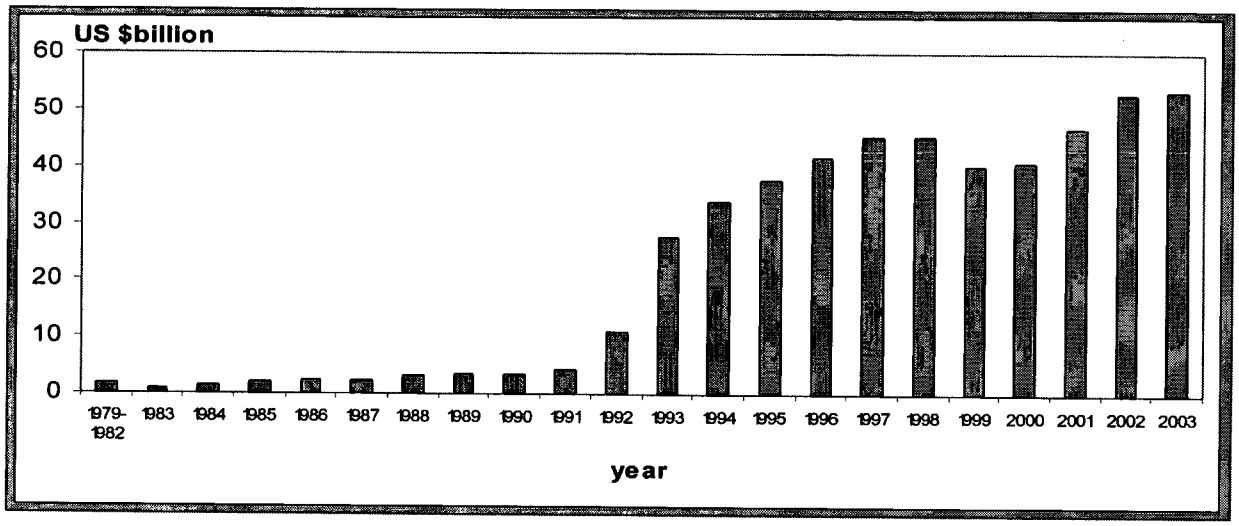
2.3.1 Uneven Development of FDI

Existing literature recognizes that the development of inward FDI in China has never been even (Wei 2003; see Figure 2.1). Since the Open Door Policy in the late 1970s China began to remove some of the barriers to the inflow of FDI (Coughlin & Segev, 2000a). During the early stages of China's economic reforms and Open Door Policy, FDI inflows to China were not significant (Wei, 2003) because FDI was attracted as "experimental" reform and confined to certain regions (Zhang et al., 2005). However, FDI inflows to China growth increased significantly in the mid-1980s and gained momentum in the early 1990s (Wei, 2003)[7]. Between 1995 and 1999 China absorbed 7.5% of global FDI flows and about one quarter of all FDI flows directed towards developing countries. In the years 1993 to 1996 China was even host to more than one tenth of the global FDI. The accumulated FDI stock of China amounted to more than 6% of the global total in 1999 (UNCTAD various; Taube and Ögütçü, 2002). Since 1993, China became the largest recipient of FDI in the developing world and the second largest host in the world, only after U.S. (SSB, 1998; Cheng and Kwan, 2000a, 2000b; Wei, 2003). In 2003, China overtook the U.S. as a destination for FDI and, with inflows of $53 billion, became the largest FDI recipient in the world (excluding Luxembourg) (World Investment Report, 2004, UNCTAD[8]).

[7] As mentioned in the previous section, Deng's South Tour is a very important event to China's FDI development.

8 See also The People's Daily at http://english.people.com.cn/200409/24/eng20040924_158173.html

Figure 2.1Trend of Realized FDI in China



Source: Zhang et al., 2005

Taube and Ögütçü (2002) suggest that this unbalanced growth experience is due to a bundle of factors which include: 1) political reasons including the role a region has been alloted in the reform process; 2) the degree of local autonomy from the central government; 3) the degree of reform mindedness and entrepreneurial spirit of the local administrative bodies; 4) historical reasons including parameters such as the involvement in former economic policy campaigns, the third front strategy and the resulting effects on the local industry structures, and the emigration of parts of the population which prospered in other regions of the world; and 5) geographical reasons including the existence of natural resources and access to the seaports.

2.3.2 Statistical Bias in the Volume of FDI

Some studies (Fung, 1996, 1997; Chen, 1997; Siu et al., 2003; Wei, 2003; World Investment Report, 2004, UNCTAD; Geng, 2004; Bajpai & Dasgupta, 2004; Dasgupta, 2004; Arabi, 2005) acknowledge the potential problems in the FDI statistics in China. Wei (2003) suggests two major reasons to explain why the volume of FDI in China as

reported by official agencies may be an overestimate: 1) the overvaluation of capital equipment's contribution to joint ventures by foreign investors; 2) 'round-tripping' investment.

In 'round-tripping' investment, it has been frequently estimated that a significant portion of the investment from Hong Kong to China originates from China itself, or from countries outside Hong Kong (Fung, 1997), who seek to take advantage of the preferential treatment given to foreign investment (Chen and Song, 2003; Geng, 2004). Geng (2004) suggests four motives for round-tripping FDI. First, tax advantages and fiscal incentives. Second, better protection of property rights. Third, expectations on exchange controls and exchange rates. Last, to take advantage of the financial services available in Hong Kong.

A similar study from the World Investment Report (UNCTAD, 2004) suggests indirect FDI undertaken by foreign affiliates in Hong Kong and round-tripping characterize a good part of the investment from this economy. World Investment Report (UNCTAD, 2004) suggests that Hong Kong is the largest outward direct investor among developing economies and the seventh largest overall contributor to global outward FDI stock. Hong Kong registered the highest levels of outward FDI in the world, but those data need to be interpreted with caution; they include significant amounts of round-tripping and indirect FDI. (World Investment Report, 2004, UNCTAD). Siu et al. (2003) also suggest that much of China's capital outflow that takes place either through legal or illegal channels to Chinese firms located in Hong Kong finds it way back to China as FDI. This type of 'round tripping' of funds is mostly used to escape regulations such as barriers to trade, or to gain eligibility to incentives available to foreign only investors (e.g. tax concessions) (Siu et al., 2003).

According to the World Investment Report (UNCTAD, 2004), 'round-tripping 'accounts for 25 per cent to 40 per cent of FDI in China. However, another estimation from Geng (2004) suggests that 'round-tripping' accounts for 30 per cent to 50 per cent of FDI in

China. Geng (2004)[9] suggests that whenever there is round-tripping FDI, inflow statistics as reported by China will be higher than the FDI outflow statistics as reported by the source country, since there will be no incentive for foreign investors to report their false investment in China in their home countries.

On the other hand, Wei (2003) suggests that FDI in China is also likely to be understated because China defines FDI at the level of at least 25 per cent of a firm's equity which is much higher than the threshold level set in OECD countries of 10 per cent. Huang (2003) also suggests that the difference statistical thresholds for FDI may impose some problems to compare the specific dollar amount of FDI between China and other countries, because the Chinese definition precludes those foreign investments that establish an equity stake of between 10 and 25 per cent in a Chinese firm. Huang (2003) notes that under the Chinese classification system, for example, most foreign purchases of China's B shares are not counted as FDI because they usually amount to about 10 per cent of the issuing firms' equity. Ford purchases 20 per cent of the B shares of Jiangling Motors in 1995, which would not count toward FDI by the Chinese definition (Huang, 2003).

For these reasons, Wei (2003) suggests that it is difficult to identify the direction of bias in the data, and most studies acknowledge the problem and urge caution in interpreting it. This caveat also applies to my study.

2.3.3 Statistical Bias of FDI by Nationality of Source Countries

A few studies have pointed to the statistical bias of FDI by nationality of source countries (e.g. Chen, 1997; Lemoine, 2000; Graham and Wada, 2001; Hou, 2002; Taube and Ögütçü, 2002; Siu et al., 2003; Breslin, 2003; Wei, 2003; Arabi, 2005). Wei (2003)

[9] Geng (2004) suggests that an indication of round-tripping can be obtained by comparing FDI inflow statistics as reported by China and FDI outflow statistics as reported by a capital exporting country. A proportion of the discrepancy between the two sources will be due to normal statistical reporting error, due to inconsistencies of definition between countries, and the remainder Geng (2004) treats as round-tripping FDI. To isolate the former source of discrepancy, Geng (2004) uses the conservative assumption that is it one half of the standard deviation of the unverifiable element of FDI flows. Using this approach and a number of simplifying assumptions, estimates are obtained that range from a low of 30% of official FDI flows to a high of 50% of official FDI flows, with a most likely estimate at 40% (Geng, 2004)

suggests that Chinese official data on FDI by nationality of source countries may be biased, partly because of the round-tripping problem addressed in the previous section, and partly because of the diversity of overseas Chinese investors.

Chen (1997) states that the FDI in China by country of origin, on the one hand, presents significant diversification in terms of the total number of investing countries; and on the other hand, it also shows great concentration in terms of the overwhelming dominance of developing source countries, particularly the Asian newly industrialized economies (NIEs).

While the number of FDI source countries in China is quite large, a handful countries account for the sums invested (See Table 2.6, Table 2.7 and Table 2.8). Reviewing the accumulated FDI stock in China untill 2002, the top five investors are Hong Kong, Taiwan, the United States, Japan and Korea (See Table 2.7; MOFCOM, 2004). However, the bulk of these massive FDI inflows into China did not stem from the world economy's industrial growth centres (Taube and Ögütçü, 2002). The main sources of China's FDI have been Hong Kong and Taiwan (See Table 2.7 and Table 2.8). Together these two source areas have accounted for more than 40 per cent of China's FDI receipts in the year 2002, and nearly 40% per cent of China's FDI receipts in the year 2003 (See Table 2.6). Hong Kong comes first as a single investor while the Asian NIEs have been the largest investors as a group. However, these two sources are inseparable, as a significant amount of investment from Taiwan is channeled through Hong Kong (Arabi, 2005). Four ASEAN countries (Thailand, the Philippines, Malaysia, Indonesia) have substantially increased their presence in China since the early 1990s. Among the developed countries, Japan and the United States have been the most important investors in China. The other developed countries have made rather small amounts of investment in China, even though they have shown an increasing interest in China in recent years (See Table 2.6, Table 2.7; OECD, 2000).

Wei (2003) suggests that Hong Kong, Macao and Taiwan were not the only sources of ethnic Chinese investors as some FDI from other Asian, European, Australian and North

American countries was also undertaken by people of Chinese extraction. Wei (2003) also indicates that the FDI from Hong Kong and Macao not only includes investments from Hong Kong and Macao but also investment flows from Taiwan and Southeast Asian countries.

Three major characteristics have been identified with the significant Hong Kong FDI flows in China (Fung, 1996; Chen, 1997; Lemoine, 2000; Wei, 2003), including political consideration, two-stage investment, and the round-tripping problem.

It is partly due to political considerations that appear to have compelled countries such as Indonesia and Taiwan to route their investment through Hong Kong (Wei, 2003). In Taiwan's case, a significant amount of TDI is channelled through Hong Kong because the Taiwanese government bans TDI in China. (Fung, 1996; Chen, 1997; Lemoine, 2000; Wei, 2003);

"Two-stage" investment happens when some of the investment is undertaken by subsidiaries of the MNEs. This problem is caused by recording the source country as being that of the country where the subsidiary is located rather than the head office country. In the case of China this problem is most likely to happen when the FDI is carried out by the developed countries' MNEs' subsidiaries based in developing countries, particularly in Hong Kong. This will tend to increase the share of developing countries in China's total FDI inflows (Chen, 1997).

Round-tripping involves the circular flow of capital out of China (in most cases to foreign affiliates of Chinese transnational corporations) and the subsequent "re-investment" of this "foreign" capital in China for the purpose of benefiting from fiscal entitlements accorded to foreign investors (Chen, 1997)

Chen (1997) asserts that the characteristics of (2) and (3) of Hong Kong FDI in China has been reduced recently. The reasons are i) in 1993 China decided to introduce national

treatment for foreign affiliates for both domestic and foreign firms. This policy reform has substantially reduced the incentive for round-tripping; ii) China has been improving its overall investment environment, which will reduce the transactions costs to the developed countries who conduct FDI in China. This will greatly help to solve the problem of two-stage investment.

Table 2.6 Accumulated FDI Stock in China till 2002 (unit: US$100 million)

Country/area	Items	%	Contracted Amount	%	Realized Amount	%
Total	424,196	100	8,280.6	100	4,479.66	100
Hong Kong	210,876	49.71	3,738.06	45.14	2,048.75	45.73
Taiwan	55,691	13.13	614.71	7.42	331.10	7.39
United States	43,320	10.21	866.59	10.47	432.47	9.65
Japan	25,147	5.93	495.32	5.98	363.4	8.11
Korea	22,208	5.24	274.76	3.32	151.99	3.39
Singapore	10,727	2.53	401.5	4.85	214.73	4.79
Macau	7,824	1.85	107.92	1.3	47.73	1.07
Germany	3,053	0.72	143.22	1.73	79.94	1.78
France	2,033	0.48	71.92	0.87	55.43	1.24
Italy	1,840	0.43	31.93	0.39	22.29	0.5
UK	3,418	0.81	196.33	2.37	106.96	2.39
Canada	6,040	1.42	103.77	1.25	33.58	0.75
Virgin Islands	6,659	1.57	493.48	5.96	243.88	5.44

Source: MOFCOM, 2004. http://www.mofcom.gov.cn/index.shtml

Table 2.7 Top Foreign Investors in China, 2002-2003 (unit: US$10,000)

Country/Areas	2002		2003	
	Realized FDI amount	%	Realized FDI amount	%
Total	5,274,286	100	5,350,467	100
Hong Kong	1,786,093	33.86	1,770,010	33.08
Virgin Islands	611,739	11.60	577,696	10.80
USA	542,392	10.28	419,851	7.85

Japan	419,009	7.94	505,419	9.45
Taiwan	397,064	7.53	337,724	6.31
South Korea	272,073	5.16	448,854	8.39
Cayman Islands	117,954	2.24	86,604	1.62
Singapore	233,720	4.43	205,840	3.85

Source: State Statistical Bureau, China Statistical Yearbook, 2004.
(http://www.stats.gov.cn/tjsj/)

Table 2.8 Top Foreign Investors in China in 1999. (Unit: US$1 million)

Country/areas	Realized amount	%
Total	40,319	100
Hong Kong	16,363	40.58
United States	4,216	10.46
Japan	2,973	7.37
Virgin Islands	2,659	6.59
Singapore	2,642	6.55
Taiwan	2,599	6.45
Germany	1,373	3.41
South Korea	1,275	3.16
UK	1,044	2.59
France	884	2.19
Netherlands	542	1.34
Cayman Islands	378	0.94
Canada	314	0.78
Macao	309	0.77
Australia	263	0.65
Others	2,484	6.16

Source: State Statistical Bureau, China Statistical Yearbook, 2000.
(http://www1.mofcom.gov.cn/moftec_cn/)

2.3.4 Uneven Sectoral Distribution of FDI

FDI in China is characterized by a very uneven sectoral distribution (Broadman and Sun, 1997; Tseng and Zebregs, 2002; Zhang, 2002; Wei, 2003). In sectoral distribution of FDI, the largest portion of FDI is destined for manufacturer and the next is real estate (Tseng and Zebregs, 2002). Among the manufacturing sectors, about half of FDI has been directed toward labour-intensive manufacturing, such as textiles and clothing, food processing, furniture (Tseng and Zebregs, 2002).

The major proportion of FDI is drawn for the manufacturing field, which takes up almost 60 per cent of the total contracted FDI by 1998 (OECD, 2000). Statistical data from MOFCOM (2004) shows FDI inflow in China that was invested in manufacturing accounting for 71.34 per cent of the total FDI (See Table 2.9). Wei (2003) suggests that most of the FDI, between 1979 and 1998, was in manufacturing industries, especially in such labour-intensive sectors such as textiles, clothing and assembly lines of mechanical, electronic and electric products, which were all in line with China's comparative advantages. Unlike the U.S. and other developed economies, China had explicit policies to encourage the 'export processing' type of FDI and set up different economic zones for foreign investors (Cheng and Kwan, 2000a, 2000b). Sung (2000) notes that processed exports generated from FDI have constituted over half of the exports of China.

However, many scholars (e.g. Wei, 2003; Buckley and Meng, 2005) suggest that the "export processing" type may have been changing from time to time after China officially joined the WTO in November 11, 2001. For example, Wei (2003) expects that such service sectors as finance and telecommunications will account for increasing volumes of FDI with China's accession to WTO and further liberation. This implies that China's FDI policy has changed from an exported-oriented to a market-oriented policy.

Table 2.9 Sectoral Distribution of FDI in China for 2003

Sector	No. of project	Share %	Contractual value	share %	Realized Value	Share %
Total	41,081	100	1,150.7	100	535.05	100

Agriculture, Forestry, Animal Husbandry & Fishery	1,116	2.72	22.76	1.98	10.00	1.87
Mining	211	0.51	6.56	0.57	3.36	0.63
Manufacturing	29,307	71.34	807.47	70.17	374.67	70.02
Production and Supply of Power, Gas and Water	333	0.81	20.73	1.8	12.95	2.42
Construction	396	0.96	16.77	1.46	6.12	1.14
Transport, warehousing, post & Telecommunication	506	1.23	50.15	4.36	8.67	1.62
Wholesale, Retailing	2,207	5.37	23.84	2.07	11.16	2.09
Finance	23	0.06	3.19	0.28	2.32	0.43
Real Estate	1,553	3.78	91.06	7.91	52.36	9.79
Lease and Business Service	458	1.11	24.2	2.1	17.2	3.21
Scientific Research, Technology Service and Geological Prospecting	574	1.4	8.04	0.7	2.76	0.52
Resident Service and other Service	4,242	10.33	70.42	6.12	31.61	5.91
Education	70	0.17	2.82	0.25	0.58	0.11
Health Care, Social Security & Social Welfare	85	0.21	2.69	0.23	1.27	0.24

Source: MOFCOM, 2004; http://www.mofcom.gov.cn/index.shtml

2.3.5 Regional Bias

Existing studies agree that FDI in China is highly concentrated geographically (Chen, 1997; Broadman and Sun, 1997; Lemoine, 2000; OECD, 2000; World Investment Report, 2002, UNCTAD; Bao et al., 2002; Wei, 2003; Fung, 2004; See Table 2.10). These regional biases result in: i) The majority of FDI in China being located in four coastal provinces (Guangdong, Jiangsu, Fujian, and Shanghai) and most of the rest of this FDI is located in other coastal provinces; and ii) A highly unbalanced picture is reproduced when looking at the province level. This section reviews the regional bias and explores the reasons for regional bias.

(1) Coastal Provinces

The FDI patterns in China show a great disparity among regions. Bao et al. (2004) investigate the geographic effects on regional economic growth in China under market reforms. This study finds that geographic factors are statistically significant in explaining the regional disparity in China. This disparity is mainly a coast versus non-coast gap. Fung (2004) identifies the three provincial groups of the eastern, central and western regions experienced different patterns in FDI inflows. In fact, most of China's FDI still flows to the east and coastal areas (Fung, 2004).

For the period from 1983 to 1998, FDI in the eastern region took up 87.8 per cent while the central region attracted 8.9 per cent and the western region recorded only 3.3 per cent (OECD, 2000). In 2002, the east and southeast coastal areas (Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Hainan, Beijing, Tianjin, Hebei, Liaoning and Guangxi) received 89.5 per cent of all realized FDIs (Fung, 2004). Therefore, the gap between the eastern region and the central and western regions in terms of the absolute magnitude of annual FDI inflows has actually broadened since 1992 (OECD, 2000).

(2) Province Level

The highly unbalanced picture is reproduced when looking at the province level (OECD, 2000; Taube and Ögütçü, 2002). Among all regions in China, Guangdong's performance in attracting FDI has been very impressive. As Hong Kong's neighbour and as the most dynamic province of China (Zeng, 1999), the province of Guangdong, and especially its Pearl-River Delta Region, have, since the early 1980s, gone through a tremendous growth process propelling the province to the top of China's most affluent regions. With an average real GDP growth of 14.2% per year Guangdong by far surpassed the national economy, which grew by only 8% (Lan, 1999).

Guangdong's share of accumulated FDI stock in the 1980s was 46.13 per cent of the national total, far exceeding all other provinces including Jiangsu and Fujian. In the 1990s, when the volume of China-bound FDI rose exponentially, Guangdong still hosted

more than one quarter of the national FDI stock (Lan, 1999; Taube and Ögütçü, 2002). Taking the period as a whole, Guangdong has absorbed nearly one third of all FDI stock which China had attracted since the beginning of the reform era. More interestingly, The FDI of Guangdong itself has also been highly concentrated in a few localities (i.e. the Pearl River Delta and the Shantou area) (OECD, 2000; Taube and Ögütçü, 2002). There is a very strong concentration of industrial activities of enterprises funded by entrepreneurs from Hong Kong, Macao and Taiwan in Guangdong (Taube and Ögütçü, 2002).

(3) Explanations for Regional Bias

The reasons for regional bias include; the economic or geographical proximity which works to facilitate investment from overseas Chinese, and China's FDI policy, which has been selective.

Chen (1997) suggests that economic proximity may cause regional biases. The evidence for this regional investment bias was found by the high concentration of Hong Kong and Macao and Taiwan's investment's in Guangdong (Taube and Ögütçü, 2002), Taiwan's investment in Fujian[10], and Japan's investment in Liaoning. Chen (1997) states that the level of "economic proximity" can explain the regional investment bias. Economic proximity works to facilitate investment and tends to reduce the transaction costs of investment (Chen, 1997).

Another reason for regional bias was partially due to China's FDI policy, which has been selective and cautious (Wei, 2003). Tseng and Zebregs (2002) suggest this uneven geographical development pattern stems from the FDI policies pursued by the Chinese government and reflects the incremental nature of the reform process in China. Wei (2003) also agrees that regional imbalances were to be expected given the stage and strategy of China's development. It has included preferential treatment in term of tariff exemption and fiscal reductions in areas in which FDI has been encouraged (Lemoine,

[10] Except Fujian, Taiwanese firms are also concentrated in Guangdong, especially in Dongguan.

2000). For example, the FDI in China was restricted to four SEZs in the early years of the Open Door Policy. FDI was then gradually allowed in fourteen coastal cities, which offered better economic endowments, such as geographic proximity to international market, better transport infrastructures, and more skilled labour over inland provinces (Lemoine, 2000; Wei, 2003). Furthermore, FDI has been encouraged to flow into the inner areas in recent years. Thus regional imbalances were partially planned by the Chinese government's economic development framework (Lemoine, 2000).

Table 2.10 Realized FDI Inflows into China by Region, 1997-2003 (unit: US$10,000)

Year	1997	1998	1999	2000	2001	2002	2003
Total FDI	4,525,704	4,546,275	4,031,871	4,071,481	4,687,759	5,274,286	5,294,028
Total FDI into major regions	4,490,109	4,528,389	3,993,482	4,033,289	4,636,700	5,247,126	5,294,028
Beijing	159,286	216,800	197,525	168,368	176,818	172,464	219,126
Tianjin	251,135	211,361	176,399	116,601	213,348	158,195	153,473
Hebei	110,064	142,868	104,202	67,923	66,989	78,271	96,405
Shanxi	26,592	24,451	39,129	22,472	23,393	21,164	21,361
Inner Mongolia	7,325	9,082	6,456	10,568	10,703	17,701	8,854
Liaoning	220,470	219,045	106,173	204,446	251,612	341,168	282,410
Jilin	40,227	40,917	30,120	33,701	33,766	24,468	19,059
Heilongjiang	73,485	52,639	31,828	30,086	34,114	35,511	32,180
Shanghai	422,536	360,150	283,665	316,014	429,159	427,229	546,849
Jiangsu	543,511	663,179	607,756	642,550	691,482	1,018,960	1,056,365
Zhejiang	150,345	131,802	123,262	161,266	221,162	307,610	498,055
Anhui	43,443	27,673	26,131	31,847	33,672	38,375	3,6720
Fujian	419,666	421,211	402,403	343,191	391,804	383,837	259,903
Jiangxi	47,768	46,496	32,080	22,724	39,575	108,197	161,202
Shandong	249,294	220,274	225,878	297,119	352,093	473,404	601,617
Henan	69,204	61,654	52,135	56,403	45,729	40,463	53,903
Hubei	79,019	97,294	91,488	94,368	118,860	142,665	156,886
Hunan	91,702	81,816	65,374	67,833	81,011	90,022	101,835
Guangdong	1,171,083	1,201,994	1,165,750	1,128,091	1,193,203	1,133,400	782,294
Guangxi	87,986	88,613	63,512	52,466	38,416	41,726	41,856
Hainan	70,554	71,715	48,449	43,080	46,691	51,196	42,125

Chongqing	38,675	43,107	23,893	24,436	25,649	19,576	26,083
Sichuan	24,846	37,248	34,101	43,694	58,188	55,583	41,231
Guizhou	4,977	4,535	4,090	2,501	2,829	3,821	4,521
Yunnan	16,566	14,568	15,385	12,812	6,457	11,169	8,384
Tibet	-	-	-	-	-	-	-
Shaanxi	62,816	30,010	24,197	28,842	35,174	36,005	33,190
Gansu	4,144	3,864	4,104	6,235	7,439	6,121	2,342
Qinghai	247	-	459	-	3,649	4,726	2,522
Ningxia	671	1,856	5,134	1,741	1,680	2,200	1,743
Xinjiang	2,472	2,167	2,404	1,911	2,035	1,899	1,534

Source: China Statistical Yearbook, 2005.

2.4 Motives for FDI

With expanded markets and increased volumes of trade, the motives for FDI into China have become far more complex than in the past. Following on from the characteristics of FDI in China, this section will examine at the motives for FDI in China as these will then help to identify the determinants which might influence the location choices and entry modes of MNEs. Taube and Ögütçü (2002) suggest that any analysis of the development of FDI inflows over time and their regional distribution must consider why an enterprise should engage in investment projects outside its home region.

Dunning's paradigm (1998) shows that under certain conditions it becomes profitable for the investor to produce in a foreign country rather than simply producing the goods at home and exporting it to the foreign market. Dunning (1988) identified three main motives for FDI: marketing-seeking, resource-seeking and efficiency-seeking. Dunning (1993) mentioned another motive, FDI as strategic asset seeking. Therefore, depending on the nature of the advantages that firms are seeking, four main types of FDI are distinguished with respect to investment motives (Dunning, 2000b, 1988 and 1993; Kuznecovs and Maslov, 2004; See Table 2.11): market-seeking, resource-seeking, efficiency-seeking and asset-seeking.

In the market-seeking FDI, the products of foreign investment enterprises (FIEs) are mostly interested in the domestic host market, while in resource-seeking and efficiency-seeking FDI motives, they are mostly destined for export. As China is not only the largest market in the world but provides low cost labour, multiple motives for FDI can be found in China, which will be explored in this section.

2.4.1 Resource-seeking FDI

Under resource-seeking FDI aims, MNEs, mostly exported-oriented, aim to 1) gain access to resources either not available, or too expensive, in the home country; 2) exploit interregional factor price differentials for the MNEs production process (Helpman & Krugman 1985; Taube and Ögütçü, 2002; Pershin, 2003)

Where the aim is to gain access to resources, such resources may include natural resources, raw materials, low-cost unskilled labour, the physical infrastructure (ports, roads, power, telecommunication), artificial factors[11], technological elements, innovatory aspects, and other created assets (e.g. brand names, patents), including assets embodied in individual firms and clusters (Pershin, 2003). Among all the resources in the host countries, Taube and Ögütçü (2002) assert that one of the most important determinants for resource-seeking FDI is the availability and price (efficiency wage rate) of unskilled labour.

Resource seeking FDI is also motivated by the desire to exploit interregional factor price differentials for the MNEs' production process. This type of FDI usually amounts to a vertical split of the MNEs' production process between the skills and/or the capital intensive processes at the headquarters, and the labour intensive manufacturing abroad. Under resource-seeking FDI, the MNEs are mostly export oriented (Helpman & Krugman 1985; Taube and Ögütçü, 2002).

[11] For example, the host country's policies aimed at restricting the exports of raw materials.

In the case of China, the major motive for FDI in China for the overseas Chinese is the resource-seeking FDI such as seeking low cost labour. A substantial portion of the FDI to China comes from the overseas Chinese in Asia, especially from Taiwan, Macao, Hong Kong and Singapore. Approximately over two thirds of China's FDI inflows have been consistently made by the overseas Chinese in the 1990s, and consequently, less than one-third has come from non-Chinese sources (Bajpai and Dasgupta, 2004; Dasgupta, 2004; Breslin, 2003; Wolf, 2002). The FDI from the overseas Chinese into China has essentially been a process of the relocation of export oriented labour-intensive factories from the neighboring expatriate settlements into China. As a result, the motive for FDI from the overseas Chinese was mainly resource-seeking FDI in 1990s (Bajpai and Dasgupta, 2004; Dasgupta, 2004). Even now the FDI flows from overseas Chinese sources are very large although the proportion of the FDI flows from non-Chinese sources has increased since 1994.

2.4.2 Market-seeking FDI

The previous section has concluded that the resource-seeking FDI dominated the motive for FDI in China in the 1990s. However, the motives for FDI in China have been changed over time from resource-seeking FDI to market-seeking FDI, especially since China entered the WTO.

Market-seeking FDI, is where the foreign investors tend to obtain or to improve access to the host country market. Pershin (2003) suggests that market seeking investors who posses superior technology and/or access to inputs, want to gain either access to new markets or to increase local production. Under marketing-seeking FDI, MNEs aim to 1) better adjust products to the peculiarities of the local markets, due to their proximity to the buyers 2); significantly reduce transportation costs, and 3) effectively bypass trade barriers (Zhang, 2000b; Taube and Ögütçü, 2002; Pershin, 2003).

Market size and growth are essential characteristics for countries which host marketing-seeking FDI (Pershin, 2003) because the larger market offers greater opportunities to

realize economies of scale (Zhang, 2000b). Market seeking FDI is motivated by the intention to supply a market that until then has been supplied with exports with locally produced goods. This type of FDI may be classified as "horizontal", as the production process is not split, but rather duplicated at the foreign location (Taube and Ögütçü, 2002).

The main reasons for marketing-seeking FDI are trade barriers (tariff-jumping FDI) and transport costs (e.g. Bridgestone). Therefore, host countries which impose import barriers tend to attract more marketing-seeking FDI inflows (Taube and Ögütçü, 2002; Pershin, 2003). For instance, falling protection under an agreement may have a negative impact on market-seeking FDI inflows.

Tseng and Zebregs (2002) assert two types of FDI flows which can be considered in China: domestic-market oriented flows and exported-oriented flows. Domestic-market FDI, in terms of market-seeking FDI, is mostly motivated by the size and growth of the host country, whereas export-oriented FDI, in term of resource-seeking FDI, looks mainly for cost competitiveness (Tseng and Zebregs). As mentioned before, the motives for FDI in China have changed over time since China entered the WTO and changed from a resource-seeking FDI to a market-seeking one.

2.4.3 Efficiency-seeking FDI

In efficiency-seeking FDI, the focus is neither local markets nor resources, but provision of opportunities to increase efficiency by means of utilizing government-induced structural imperfections, e.g. tax differentials, or to reduce risks by means of diversifying production. The purpose of efficiency-seeking FDI is also to make optimal use of the factors of production at the international level (Pershin, 2003).

Efficiency-seeking FDI is driven by the motivation to 1) improve efficiency through the rationalisation of the global structure of the activities of MNEs, 2) take advantage of international specialization, 3) realise economies of scale ad scope; 4) diversify the

MNEs' risk exposure; and 5) take advantage of the different comparative cost advantages of the various economies for the MNEs' production process (Taube and Ögütçü, 2002; Pershin, 2003). Efficiency-seeking FDI is, therefore, undertaken mainly by network-based MNEs with global sourcing operations, supplying many markets (Pershin, 2003).

Dunning (2002) suggests that FDI in developing countries has shifted from market-seeking and resource-seeking FDI to more (vertical) efficiency-seeking FDI. Due to globalization-induced pressure on prices, MNEs are expected to relocate some of their production facilities to low cost developing countries, such as China. Nevertheless, and in contrast to FDI in industrial countries, FDI in developing countries still dominates the access to natural resources, and national or regional markets (Nunnenkamp, 2002).

In China's case, Dasgupta (2004) suggests that the Chinese government's FDI policy is another important factor in attracting FDI into China, which is promoted by efficiency-seeking FDI. For example, some of these benefits were in the form of SEZs, which include tax holidays, hassle-free bureaucratic clearances, reasonably good infrastructure, and overall government promotion of FDI in the huge Chinese market, as well as China's huge export market. Other attractions include a corporate tax rate applied to Foreign Invested Enterprises (FIEs) of 15% for three years after a two year tax holiday once they have recorded a profit, compared to a standard 33% rate for domestic firms, as well as duty-free concessions for imported equipment, improved land use rights and other advantages (Erskine, 2004). Incentives offered by the Chinese government to FIEs also provide a motive to route funds generated in China via Hong Kong, in terms of round-tripping, and back into China as FDI to gain access to these privileges (Dasgupta, 2004).

Hsiao and Hsiao (2004) also support the view that the FDI policy is a very important motive for FDI into China, especially for FDI from Hong Kong and Taiwan. Most interestingly, Hsiao and Hsiao (2004) also suggest that there may have been political motives on the part of China to lure the Hong Kong Chinese and the Taiwanese into the

"China Circle"[12] for future "unification," but, in any case, this is a unique FDI policy that is not seen in other countries.

2.4.4 Strategic asset-seeking FDI

The purpose of strategic asset seeking is to acquire core competence from the host market (Zhang and Yu, 2004). For asset seeking FDI, a host country's created assets, including the innovatory capacity of firms, are the crucial L advantage. Dunning (1993) described a group of MNEs as "strategic asset seekers". Specific assets-seeking FDI may take a variety of forms from an innovative capability and organizational architecture for access to marketing distribution channels, and a better understanding of the local consumers' tastes (Dunning, 1994; Zhang and Yu, 2004). The increasing use of mergers and acquisitions as a means of foreign market entry can be seen as evidence that strategic asset-seeking FDI is on the rise (Wesson, 1999).

Under strategic-seeking FDI, MNEs aim to 1) shift towards knowledge-intensive assets and learning experiences that augment the investing firms' existing firm specific advantages; 2) occupy market shares and achieve learning in an early stage of market development; 3) block or inhibit business activities of competitors, 4) counter the move of a competitor already positioning itself in the foreign market (Dunning, 1998b; Wesson, 1999; Taube and Ögütçü, 2002).

Moon et al. (2003) suggest that the increasing use of mergers and acquisitions as a means of entry to the Chinese market is evidence that strategic asset-seeking FDI in China is also increasing. For example, Ford Automobile purchased additional shares of the Jiangling Automobile from 20 per cent to 30 per cent at US$55 million. Ford aimed to expand its business in the Chinese automobile market and establish strategic ties with Jaingling in the long run (People's Daily, Oct. 31, 2001; Moon et al., 2003). This is a case of strategic seeking FDI in China for FDI from USA

[12] Naughton's (1997) book is the first comprehensive study of the underlying economic dynamics that make the China Circle not only possible, but hugely successful.

Table 2.11 Dunning's Four Main Motives for FDI

Investment Type	Investor's benefits from FDI	Major characteristics of the host country	Major characteristics of the investor
Market seeking (import substituting)	Greater ability to serve the host country market	1. Large or rapidly growing market 2. Restrictions on imports (natural or artificial)	1. Privileged access to inputs 2. Oligopolistic industry
Resource seeking (supply oriented)	Greater ability to access the host country's resources	1. Availability of resources or technology 2. Restrictions on exports (natural or artificial)	1. Privileged access to markets worldwide 2. Economies of vertical integration
Efficiency seeking (rationalized investment)	Cutting down production costs as a result of greater efficiency	Favorable government policies towards investors	Privileged access to both markets and inputs
Specific assets-seeking	Augment investing firms' existing firm specific advantages.	1. Knowledge-intensive assets 2. Learning experiences	1. Very careful consideration about the choice of location 2. Knowledge-intensive sectors

Source: Dunning, 1988; Wesson, 1999; Pershin, 2003; Zhang and Yu, 2004.

2.4.5 Multiple Motives

In the previous sections four major FDI motives were reviewed. The fact is, that multiple motives may be seen behind much FDI in China, as the Chinese market is not only the largest one in the world, but also features very low labour costs (Zhang et al., 2004).

As mentioned above, the motives for FDI in China have changed since China entered the WTO. A recent study by Buckley and Meng (2005) examines export-orientated and market-orientated FDI in China's manufacturing industry. This study shows that market-orientated FDI accounts for the majority of China's total inward FDI in the manufacturing industry and has grown faster than the export-orientated FDI over the period 1992 to 2002. The study suggests that many inward investors follow a dual market strategy. This industry level analysis suggests that overseas Chinese investors are more export-orientated than Western investors. The coexistence of export-orientated (resource seeking FDI) and Chinese domestic market-orientated FDI (market-seeking FDI) is a reflection of the flexibility of MNEs to adjust and adapt ownership attributes to the local market

context. The study offers insights into the evolutionary development path taken by foreign-invested manufacturing enterprises in China.

Wang (1992) suggests that the motives for FDI in China conducted by large MNCs are different from those of small to medium sized enterprises (SMEs). This study shows that maximization of profits is beyond doubt the prime motive for investment in China by SMEs, but frequently only a secondary consideration for large MNCs with a view to the long-term strategies for future expansion, to the competition with rival companies, and to strengthening a larger share of the Far East and world production markets, and to gaining technical advantages, such as the possibility of increasing the scale of production, so enabling stood-down models to be transferred at low cost, as well as providing a more rational division of labour.

Multinational companies may be driven by multiple motives, which imposes opposing effects on imports. For example, a recent study by Zhang et al. (2004) found a lack of significance of causation from FDI to imports, which could be explained by the contradictive impact of FDI on imports. FDI may replace imports when the motive for the investment is market-seeking. However, FDI might promote imports when the motive for FDI is resource-seeking.

In summary, motives for FDI in China vary by source countries and firm size and may change over time.

2.5 Determinants of FDI

Following the motives for FDI in the previous section, this section will review the determinants of FDI. FDI is considered a powerful catalyst in market transition (Bandelj, 2002), and, the most intrinsic factor in order to define FDI is to analyze its determinants (Agiomirgianakis, 2003). This section will therefore review the recent academic research into the determinants of FDI.

A growing number of studies have investigated the determinants of FDI flows in China (e.g. Wei, 1995; Wei, 1997; Chen, 1997, Wei, 2000; Wei and Liu, 2001; Hong and Chen, 2001; Zhang, 2002; Tseng and Zebregs, 2002; Wei 2003). Wei (2003) asserts that many studies are based on the OLI framework, which use Dunning's eclectic paradigm. Dunning states that firms invest abroad due to ownership (O), locational (L), internalisation and (I) advantages. L advantages refer to the MNE's willingness to invest in one specific host country rather than in others. Internalisation advantages refer to the ability of the MNEs to internalise the O and L advantages (Wei, 2003).

Wei (2003) suggests that the determinants of FDI can be broadly categorised into two groups: studies at national level (why foreign firms invest in a specific host country) and those at regional level (why a foreign firm chooses a specific region in a host country). This section which categorizes determinants of FDI is also based on Wei's (2003) study on determinants of FDI in China.

2.5.1 National Determinants

National Determinants of FDI focus on why foreign firms invest in a specific host country, and aim to answer the question of what country characteristics could impact on the FDI inflows. This section reviews the determinants of FDI in China at national level.

Most FDI studies (e.g. Lunn, 1980; Dunning, 1994; Kawaguchi, 1994; Bevan and Estrin, 2000; Lim, 2001; Stöwhase's, 2002; Nunnenkamp, 2002; Nonnemberg and Cardoso de Mendonça, 2004) have investigated how market size, human capital, cost factors, and FDI policies or political stability of host countries influence FDI. For example, Dunning (1994) identified three sets of economic influences on FDI including: (1) market factors, such as the size and growth of the market measured by the GDP of the host country; (2) cost factors, such as the availability of labour, low labor costs and inflation; and (3) the investment climate, as measured by the degree of foreign indebtedness and the state of balance of payments.

In the case of China, most studies (e.g. Zhang and Markusen, 1999; Fu, 2000; Wei and Liu 2001; Zhang et al., 2005) have investigated some same determinants such as market size, labour costs and labour quality, but have also considered factors such as FDI policies, the exchange rate, political risk/corruption and cultural differences.

(1) Market Size

Market size is associated with the growth prospects of the host country market and is related to the level of FDI flows (Dunning, 1993). IMF (2003) also suggests that domestic market size is a major factor on FDI inflows. The empirical results from most studies (e.g. Kawaguchi, 1994; Bevan and Estrin, 2000) indicate that market size, measured by GNP, or GNP per capita, GDP or GDP per capita, has a significant and positive effect on inward FDI.

As the larger host markets reduce the cost of supplying the market because of the economies of scale and the lower fixed cost per unit of output, a larger host market will encourage market-seeking FDI (Lim, 2001). Zhang and Markusen's empirical study (1999) shows that the poorest countries attract a far smaller share of world direct investment than their share of income. A small market receives less investment per capita than the larger ones (Zhang and Markusen, 1999). Lunn (1980) found the market size of the EEC is a significant determinant for US direct investment in Europe (Lunn, 1980). For developing countries, previous studies have found that market size is a significant predictor of FDI (Root and Ahmed, 1979; Lunn, 1980; Schneider and Frey, 1985; Torrisi, 1985; Petrochilas, 1989; Wheller and Moody, 1992).

In the case of China, existing empirical results also indicate that market size is the principal determinant, measured by GDP, GDP per capita, GNP, or GNP per capita, and that there is a positive relationship on inward FDI in China at national level (e.g. Zhang, 2000a; Wei and Liu, 2001; Hong and Chen, 2001). With nearly one-quarter of the world's population, and one of the fastest rates of economic growth, China has become an attractive target for business expansion for many foreign firms (Hsiao & Hsiao, 2004).

Wan (2005) suggests that what makes China different from the other East Asian economies is its size. Zhang (2000a) finds that China's large markets attract FDI flows from both the U.S. and Hong Kong.

A recent study from Buckley and Meng (2005) found China's total inward FDI in the manufacturing industry has grown faster than export-orientated FDI over the period 1992—2002. This study suggests that China's WTO membership provides a very strong motivation for market-oriented FDI strategy. This conclusion is supported by other studies (e.g Hou, 2002; Hayashi, 2003; Zhang et al., 2005).

The driving forces behind investment in China have changed over time; prior to its accession to the WTO, China's market potential could only be tapped to a limited degree while resource-seeking FDI was promoted. The WTO membership now enables foreign companies to benefit from China's huge domestic-for-foreign products.

(2) Labour Costs

Many studies (Schoenberger, 1988; Kawaguchi, 1994; Bevan and Estrin, 2000; Lim, 2001) provide evidence to show that lower labour costs/unit labour costs are positively related to FDI inflow. Austin (1990) suggests that the wage cost advantage is a primary reason for businesses to integrate developing countries into their global production strategy (Austin, 1990).

However, a dissenting view from Kinoshita (1998) argues that availability of cheap labour is not necessarily an important factor for the Japanese FDI in Asia. Kinoshita (1998) studies the locational determinants of FDI by Japanese manufacturing firms in seven Asian countries. She suggests that different size-groups of firms react to different factors in the host country in marking their foreign investment decisions. Low labour and sufficient infrastructure encourage small firms to invest in a certain country while, for large firms, the market size of a host country and strategic considerations (e.g. whether competitors invested in the country or not) are most important for their locational

decision. She argues that the availability of cheap labour is not necessarily an important factor for Japanese FDI in Asia.

Schoenberger (1988) argued that Japanese investment in Ireland and US investment in Puerto Rica were mainly made on a cost-minimization and tariff-free market access (Schoenberger, 1988). A few studies on the determinants of FDI in developing countries suggest that labour cost differential was a significant determinant of FDI in the 1970s and 1980s (Scheneider and Frey, 1985; Wheeler and Moody, 1992).

A more recent research by Haaland and Wooton (2002) asserts that the most attractive location has a flexible labour market (low closure costs) together with a low opportunity cost of employment (high unemployment). Host countries with an inflexible labour market and high unemployment will succeed in attracting low-risk firms, while the host countries with more flexible labour markets and low unemployment will attract higher risk firms (Haaland and Wooton, 2002).

Empirical studies show that China's low labour costs play a role in foreign firm's FDI decisions at national level (e.g. Dees, 1998; Zhang, 2000a; OECD, 2000; Wei and Liu 2001). It is often argued that the labour cost in determining FDI flows should be the efficiency wage rate, which is adjusted in line with productivity rather than the "absolute wage", especially if FDI is export-oriented. In terms of the efficiency wage rate, China still has good advantages as confirmed by empirical research (OECD, 2000).

Empirical results from Wei and Liu (2001) show that China's low labour costs and relatively large volumes of exports play an important role in foreign firms' FDI decisions. Cheng and Kwan (2000a, 2000b) suggest low wage costs have been an especially important factor in attracting exported-oriented FDI from Hong Kong and Taiwan as a response to rising wage costs in their own, and other economies, in the region. Zhang (2000a) finds that labour costs play a less significant role in attracting FDI from the US than that of Hong Kong.

(3) Labour Quality

A region's human resource endowment, and/or education level, and/or labour quality may be regarded as an important differentiating factor. The non-availability of managers, engineers or skilled technicians in a given region might prove to be highly detrimental to the attraction of FDI (Taube and Ögütçü, 2002).

Some studies (Nunnenkamp, 2002; Taube and Ögütçü, 2002; Agiomirgianakis, Asteriou, Papathoma, 2003; Nonnemberg and Cardoso de Mendonça, 2004) suggest the labour quality/human capital/local skills/level of schooling are important in attracting a FDI inflow. For example, Nunnenkamp (2002) states that traditional market-related determinants are still dominant factors, and among non-traditional FDI determinants, only the availability of local skills has clearly gained any importance. Nonnemberg and Cardoso de Mendonça (2004) also find that FDI is related to the level of schooling.

In the case of China, not only labour cost, but also labour quality (or human capital) plays an important role in attracting FDI (Zhang et al., 2005). High quality of labour (or skilled labour) is a significant determinant of FDI irrespective of its country of origin (Zhao and Zhu, 2000; Wei, 2003). This implies that China's advantage over other developing economies in attracting FDI is not cheap labour alone, but the combination of cheap labour and skilled labour (Zhang et al., 2005).

(4) FDI Policies

The existing studies (Kawaguchi, 1994; Lim, 2001; Stöwhase's 2002; Agiomirgianakis, Asteriou, Papathoma, 2003) seem to agree that that legal characteristics or fiscal incentives of host countries, in form of foreign investment policies, could facilitate or deter investment inflows. For example, Stöwhase's (2002) empirical study shows that FDI in real activity (production) is corrected with effective tax rates, while FDI that implies more opportunities for profit-shifting activities (service, finance and R&D) is correlated with the statutory tax rate. Higher corporate tax rates may reduce the net profit and consequently discourage FDI (Hartman, 1981). Another recent study from

Blomström and Kokko (2003) argues that good governance in the area of FDI policy is to consider the investment incentives package as part of the country's overall industrial policy. Therefore, a host country's industrial policies in general are important determinants of FDI inflows, and effect the FDI (Blomström and Kokko, 2003).

However, a dissenting view from Nunnenkamp (2002) suggests that the tariff jumping motive for FDI had lost much of its relevance well before globalization became a hotly debated issue.

In the case of China, Fu (2000) suggests institutional change has positively impacted on the FDI inflow into China. Another study from Tseng and Zebregs (2002) also asserts that apart from the economic environment, political commitment is an important determinant in attracting FDI, when comparing other host countries with China.

(5) Cultural Difference

Studies show that culture and linguistic similarities are important determinants of FDI inflows in China. Most studies agree that fewer cultural differences will encourage FDI inflows in China (e.g. Wei and Liu, 2001; Zhang, 2001; Zhang, 2002; Tseng and Zebregs, 2002; Zhang et al., 2005). Linguistic ties also have a positive impact on FDI inflow (Wei, 2000; Zhang, 2002; Tseng and Zebregs, 2002). These connections make it much easier for overseas Chinese investors to negotiate and operate joint ventures in China, than for other investors (Zhang, 2001).

This explains why Asian investors, especially from Hong Kong and Taiwan, are dominants in China's marketplace. Zhang et al. (2005) assert that in a location with cultural similarities, investors feel more familiar and comfortable with business routines, and hence perceive a low investment risk.

Similar studies from Carlsson et al. (2004) show subsidiaries in China perform better if the firms have subsidiaries in Hong Kong, Taiwan, or Singapore. In addition, the authors

also suggest that the length of the subsidiaries' operation in China, and the experience from foreign countries outside Greater China, are also positively affecting the subsidiaries' economic performance.

The specific nature of FDI in China, particularly in the export sector, lies in the fact that the overseas Chinese have played a major role. The creation of special economic zones in south China suited the overseas Chinese. They could identify items for production, partners for joint ventures, invest huge amounts and lift products for exports through their own networks. It was estimated that in the early years, the FDI from the overseas Chinese constituted 80 per cent of the total FDI, which has since declined to 50 per cent in recent years (World Investment Report, 2002, UNCTAD). However, the role of FDI from the overseas Chinese is still very significant. Therefore, the culture and linguistic similarities are important determinants of the FDI inflows in China.

(6) Exchange Rate

Existing studies (e.g. Liu et al., 1997; Wei and Liu, 2001; Banik, 2003; Xing and Wan, 2005) agree exchange rate is a statistically significant factor that determines FDI flows. Empirical results from Liu et al. (1997) and Wei and Liu (2001) found a positive coefficient with the exchange rate variables of the FDI flows in China. Banik (2003) also has found that the variations in the exchange rate reveal a powerful indicator of FDI inflows in China.

Empirical results by Xing and Wan (2005) also show that the relative exchange rate is a statistically significant factor that determines the relative inflows of Japanese FDI for manufacturing as a whole, and for such sub-sectors as textiles, food, electronics, transportation equipment, and others. The authors also found that exchange rate polices of China and ASEAN-4 played a critical role in dynamically reshaping the geographic distribution of Japanese FDI in Asia. This paper advances the existing literature by showing that relative FDI is determined by the relative real exchange rate between the currency of the recipient country and that of the source country. A relative real

appreciation in the currency of a recipient country will reduce its FDI inflows and divert investment to its rival country (Xing and Wan, 2005).

Empirical results by Russ (2004) provide a theoretical account of the link between FDI flows and the correlation between local demand and exchange-rate volatility investigated by Goldberg and Kolstad (1995). This study bears the important and empirically testable implication that the variance of the exchange rate will impact the MNE's decision to enter a market, but whether it encourages or deters firms contemplating direct investment depends on whether the shocks originate in the company's own native country or overseas, in the host market (Russ, 2004).

(7) Political Risk and Corruption

Existing international business literature has acknowledged the importance of country-specific political risk (Kobrin, 1976; Globerman & Shapiro, 2002). Political/economic stability or country risk (Bennett and Green, 1972; Bevan and Estrin, 2000; Lim, 2001; Nonnemberg and Cardoso de Mendonça, 2004) is one of the major determinants on FDI inflow at national level, although it is difficult to generalize about the statistical impact of political governance attributes, in part because these attributes are measured in different ways in different studies (Globerman & Shapiro, 2002).

Bennett and Green (1972) argued that political instability provides a more hostile environment for foreign corporations, therefore discouraging their investment. Bevan and Welfens (1993) assert that in transition economies like those of Central and Eastern Europe, a set of credible political institutions, and stabilizing monetary and fiscal policies are also needed to attract FDI inflows. Estrin (2000) finds that country risk is influenced by private sector development, industrial development, and the government balance, reserves and corruption. Wei (1997) also suggests that corruption has negative and significant effects on FDI. Furthermore, Wei (1997) found no support for the view that foreign investment is less sensitive to corruption in East Asia.

However, there is a dissenting view from Chantasasawat et al. (2004b). This study examines the significance of institutional factors in the determination of FDI by incorporating the level of corruption as an indicator of the rule of law and as an indicator of the stability of Latin America, East and Southeast Asia and China. The empirical results show that corruption, instability and the rule of law play no role in FDI flows in Latin America, East and Southeast Asia or China. Chantasasawat et al. (2004b) suggest that market sizes and policy variables, such as openness and corporate tax rates, tend to be more important.

In summary, the literature reviews found that the determinants of FDI at national level include market size, labour cost, labour quality, FDI policies, cultural difference, exchange rates, and political risk and corruption, which could all facilitate or deter investment inflows. There does not yet appear to be consensus on all the important determinants of FDI in China in the existing empirical literature. This is partial because there are different types of FDI in China, which are affected by different determinants. While certain determinants, such as market size and different measures of labour costs, are usually included in the empirical models, other determinants choosen may vary significantly across models. Of the studies surveyed, the most important determinant is market size. Market size proxied by GDP and GDP per capital, is highly significant and impacts positively on FDI flows in China in all studies. This may reflect the feature of China's huge domestic market.

2.5.2 Regional Determinants

Determinants at regional level answer the question of why a foreign firm chooses a specific region within a host country. Foreign investors do not focus their investment in the same area because they appear to accord different weights to various locational characteristics (Little, 1978). Profit-seeking companies, therefore, will explore the location-endowed assets from a variety of locations (Dunning, 1998b). There has been a considerable literature about why MNEs invest in specific locations (e.g. Dunning, 1993; Coughlin and Segev, 2000b; Haaland and Wooton, 2002; Blomström and Kokko, 2003).

In the case of China, most studies at regional or national levels (e.g. Zhang and Markusen, 1999; Fu, 2000; Wei and Liu 2001; Zhang et al., 2005) have investigated some same determinants such as market size, labour costs and labour quality, but studies at regional level have also considered determinants such as agglomeration effects, infrastructure and FDI investment incentives. This section explores the major locational determinants of FDI as follows.

(1) Market Size

Most studies agree that economic size or market size is an important determinant of locational choices of FDI (e.g. Zhang and Markusen, 1999; Coughlin and Segev, 2000b; Lim, 2001) as it can be used to evaluate the potential demand of a region (Taube and Ögütçü, 2002).

In China's case, existing empirical results indicate that market size is the principal determinant, measured by GDP, GDP per capita, GNP, or GNP per capita, and it has a positive relationship on inward FDI in China at regional level (Broadman and Sun, 1997; Coughlin and Segev, 2000a; Fung et al., 2000; Wei and Liu, 2001, Zhang, 2002; Zhang et al., 2005).

Cheng and Kwan (2000a, 2000b) found that large market size has a positive effect in FDI inflows in China at regional level. Wei et al. (1999) and Wei and Liu (2001) also suggest that the growth of a regional market proxied by GDP growth is found to have a statistically significant impact on contracted FDI inflows. Research from OECD (2000) has shown that the provinces with larger GDP, higher per capita income and a higher level of accumulated FDI stock have attracted relatively more FDI inflows (OECD, 2000).

(2) Labour costs

Though different measures are adopted, empirical studies show low labour costs play a role in the locational choices of FDI at regional level (e.g. OECD, 2000; Cheng and Kwan, 2000a; Coughlin and Segev, 2000a; Sun et al. 2002; Fung et al., 2002). For

example, OECD (2000) suggests that higher labour costs (approximated by efficiency wages and lower labour quality) have actually deterred FDI inflow.

However, a dissenting view from Zhang (2002) suggests that the decision on where to invest in China is based more on cultural background and specific incentives offered by local governments rather than the comparative wage rates within China.

(3) Labour Quality

Regarding general education, Broadman and Sun (1997) assert that level of general education has a positive impact on the geographical distribution of FDI within China. The educational level of the country can be measured directly by adult literacy rates (Wei, 1995b), which have a broad impact on many issues of economic development, such as the quality of labour, a better understanding of new things and a more open attitude to new things (Zhang et al., 2005).

There are, however, arguments about whether the high quality of labour has a significant effect in attracting FDI in China. Most studies show that high quality labour has a significant effect in attracting FDI (e.g. Zhang and Zhu, 2000; ; Fung et al., 2002World Investment Report 2004 UNCTAD) but empirical results from Cheng and Kwan (2000a, 2000b) do not support this opinion.

Two empirical studies by Cheng and Kwan (2000a, 2000b) do not detect any significant role of labour quality in the location of FDI in China. However, Gao (2004) use recent data on Chinese provincial-level FDI by investing country and find that labour quality plays a significant and positive role in attracting FDI. Furthermore, the evidence in this paper indicates that the location of FDI from developed economies such as the United States and Japan is more sensitive to labor quality than FDI from Asian developing economies.

(4) Infrastructure/Transportation Costs

A few studies agree that transportation costs or transportation infrastructure is positively related to FDI (e.g. Coughlin et al., 1991; Brandard, 1997; Coughlin and Segev, 2000b). However, Ekholm (1998) suggests that transport costs are only weakly related to FDI.

In China's case, existing literature agree (e.g. Broadman and Sun, 1997; Cheng and Kwan 2000a, 2000b; OECD, 2000; Tseng and Zebreg 2002; Zhang, 2002; Ng and Tuan, 2003; Fung et al., 2005) that infrastructure development tends to play an important role in foreign investors' location decisions worldwide in the geographical distribution of FDI within China.

Zhang (2002) suggests that a sound transportation network, measured by more railroad and highway in kilometers per square per province, is positively related to FDI flows in China. Another study by Fung et al. (2005) examines whether hard infrastructure in the form of more highways and railroads, or soft infrastructure in the form of more transparent institutions and deeper reforms, lead to more FDI. This study uses data of FDI from the United States, Japan, Hong Kong, Taiwan and Korea to various regions of China from 1990 to 2002. This study found empirically that soft infrastructure consistently outperforms hard infrastructure as a determinant of FDI.

(5) Agglomeration

A growing literature suggests that agglomeration factors have a positive impact on FDI (e.g. Wheeler and Mody, 1992; Head et al., 1995; Moran, 1998; Fung et al., 2000; Coughlin and Segev, 2000b; Lim, 2001). For example, Head et al. (1995) found industry level agglomeration effects play an important role in location decisions.

Agglomeration effects are most commonly proxied by the quality of infrastructure, the degree of development/industralization, and the lagged stock of FDI, but these variables may influence FDI through other channels as well (Lim, 2001; Demekas, 2005).

Agglomeration has a positive relationship in attracting FDI, which suggests that once a region has attracted a significant mass of FDI, it will be easier for it to attract more as foreign investors perceive the presence of other foreign investors as a positive signal (Cheng and Kwan 2000a, 2000b; OECD, 2000; Tseng and Zebregs 2002; Zhang, 2002; Jiang, 2003). Tseng and Zebreg (2002) call this kind of FDI attraction, 'scale effect', which suggests that the greater the amount of investment, then the greater the confidence of others to invest. Jiang (2003) also suggests that once a specific industry has been established in an area, others will then follow to take advantage of the existing support for that industry.

In the case of China, a few studies (e.g. Cheng and Kwan 2000a, 2000b; Tuan and Ng, 2002; He, 2003b; Tuan and Ng, 2004; Tseng and Zebregs, 2002) agree that the agglomeration effect on FDI itself is positively related to FDI inflows.

Tuan and Ng (2002) suggests that under agglomeration economies, a firm's location decisions would follow a relationship described by the gravity model in choosing their plant locations. Within a given distance from the core, firms would prefer sites with higher firm agglomeration. Another recent paper by Tuan and Ng (2004) found that a significant spatial concentration of FDI is viewed as reflecting agglomeration effects generated in selected regions and that these are put forward as the main explanation for the observed spatial pattern of FDI.

He's (2003b) research also finds that agglomeration economies derived from the clustering of manufacturing and foreign investment activities, combined with better access to markets, influenced the location of foreign manufacturers. Using data from China, He (2003b) finds that agglomeration economies derived from the clustering of manufacturing and foreign investment activities, combined with better access to markets, and influenced the location of foreign manufacturers.

Another interesting point from Arabi (2005) suggests that FDI in China is also driven by 'peer pressure' since many firms have followed their competitors into China to put

pressure on their significant investments in Mainland China. 'Peer Pressure' to some extent can be referred to as agglomeration effects.

However, a dissenting view from Tong and Yu (2001) suggests cumulative FDI, relative to cumulative domestic investment, has a negative impact on the new FDI. This study suggests that provincial officials have to improve the investment environment. Otherwise, MNEs may choose to invest in provinces with few FDI competitors. Tong and Yu (2001) state that this study explains the FDI distribution in the coastal provinces better than it does for Central and Western provinces because of the difference in the investment environment.

(6) FDI policies

Most studies (e.g. Broadman and Sun, 1997; Cheng and Kwan, 2000a, 2000b; Coughlin and Segev, 2000b; Tung & Cho's, 2001; Tseng and Zebregs, 2002; Zhou et al., 2002; Zhang, 2002; Zhang et al., 2005; Chen et al., 2005) agree that policies and institutional determinants play an important role in FDI flows in China.

Broadman and Sun (1997) suggest that a coastal location is an important determinant of locational distribution of FDI within China. It implies that the policy incentives are important to FDI inflows in China. Coughlin and Segev (2000b) found that taxes are found to deter new plants for foreign investors. Tung & Cho's (2001) empirical results also indicate that tax rates and incentives are important determinants of regional investment decisions in China, after controlling for the potential confounding of variables covering infrastructure, the rate of unemployment, the wage rate and agglomeration economics. This study suggests that zones and cities with lower tax and greater tax incentives attract more FDI. For example, the World Investment Report (2004, UNCTAD) suggests that Shanghai uses tax incentives to attract regional headquarters.

However, existing literature (e.g. Head and Ries, 1996; Fung et al., 2002; Breslin, 2003) also acknowledges that there is considerable competition from the various industrial

zones to attract investment (Head and Ries, 1996; Breslin, 2003). Zhou et al. (2002) examined 2,933 cases of Japanese investment in 27 provinces and regions in China to identify the role that policy determinants had in influencing the sub-national location decision of Japanese firms in China. The empirical results show that the Special Economic Zones (SEZs) and Open Coastal Cities (OCCs) were a successfully policy instrument initially. However, since the mid-1990s SEZs and OCCs have attracted proportionally less FDI as competition from other special investment zones intensified in China.

Recent studies also suggest that another potential factor is China's accession to the WTO, which should broaden China's "opening up" policies and continue FDI inflows to China in the future (Tseng and Zebreg, 2002; Zhang et al., 2005).

Fu's (2000) study demonstrates a systematic link between institutional changes in China's FDI regulatory framework and the changing patterns of FDI. Institutional determinants are more fundamental than other macroeconomic determinants or societal determinants (Fu, 2000). Zhang et al. (2005) suggest that the liberalization of FDI regimes and creation of new institutions are significant determinants of FDI in China. This study finds that at the turning points of the development curve of FDI, there are always institutional breaks or important events accompanying these, which highly influenced the inflows of FDI, either by increasing foreign investors' confidence or weakening their confidence in investing in China. These important institutional determinants listed by Zhang et al. (2005) include the Equity Joint Venture Law in 1979, regulations for the implementation of the Joint venture Law in 1983, the Tian'anmen Square incident in 1989, Deng Xiaoping's Southern Journey in 1992, provisions on guiding FDI in 1995, and constitutional amendment which included private enterprises being acknowledged in 1999, and China's entry into the WTO in 2001 (See also Table 2.3 and Table 2.5).

However, a dissenting view from Chen and Song (2003) suggested that as FDI from developing countries, such as Hong Kong and Taiwan, can always find informal channels to solve problems, such as friction and complex procedures, they do not have a strict

request for institution infrastructure in the investment environment. For example, at least approximately 50% of the Hong Kong FDI represented a recycling of capital from Mainland China, called " round-tripping FDI", which sought to take the advantage of the preferential treatment given to foreign investment (Chen and Song, 2003).

In summary, existing literature suggests that the common determinants at regional level include market size, agglomeration effects, infrastructure, labour quality, labour costs and FDI incentives. Similar to the conclusion from determinants of FDI in China at national level, there does not yet appear to be a consensus on all the important determinants of FDI in China at regional level. The most important determinant again is market size. Market size proxied by GDP, GDP per capital, is highly significant and positive on FDI flows in China in all studies at regional level.

2.6 Entry modes of FDI

The manner in which a firm chooses to enter a foreign market through FDI is referred to as entry mode. The choice of market entry mode is a critical strategy decision for firms intending to conduct business overseas (Root, 1994; Nako and Brouthers, 2002).

A few studies (eg. Johanson and Vahlne, 1977, 1990; Root, 1987; Hennart and Larimo, 1998; Gomes-Cassares, 1990; Pan and Tse, 2000; Zhang and Yu, 2004) have identified several factors that determine the choices of a specific foreign market entry mode.

This section gives a brief review on the market entry mode literature which includes: 1) classification of FDI by entry mode; 2) major theories on choices of entry modes; and 3) determinants of entry modes of FDI in China.

2.6.1 Classification of FDI by Entry Modes

There has been a long debate concerning the types of major entry modes. Agarwal and Ramaswami (1992) identified four common modes of foreign market entry, including

exporting, licensing, joint ventures, and sole ventures. Root (1994) identifies three main entry modes for manufacturers in serving a foreign market: exporting, contractual and investment. Pan and Tse (2000) propose a hierarchical model of market entry modes. In their entry theory, entry modes can first be viewed as equity-based versus non equity-based. Within equity-based modes, the choice is between wholly owned operations and equity joint ventures, while within non-equity-based modes, the choice is between contractual agreements and export. Pershin (2003) classified five entry modes for FDI: greenfield, brownfield, expansion, acquisition and joint ventures.

A few studies (e.g. Deng, 2001; He, 2003; Tseng and Zebregs, 2002; Hayashi, 2003) identified the main forms of entry modes in absorbing of FDI into China: EJVs, CJVs and WOEs. An interesting study from Wei and Liu (2004) states that in terms of FDI entry strategy, the existing literature tends to focus on a binary choice between wholly owned enterprises (WOEs) and equity joint ventures (EJVs) or between greenfield investment and acquisition. Wei and Liu (2004), however, argue the major entry modes of FDI in China should include WOEs, EJVs, CJVs and JSCs. Wei and Liu (2004) state four major entry modes of FDI in terms of WOEs, EJVs, CJVs and JSCs, which are all involved in the ownership and control by foreign partners, and officially recorded as FDI by both the Chinese government and world organizations such as the United Nations (UNCTAD). Therefore, Wei and Liu (2004) suggest that a systematically study of FDI entry strategy should include all these modes.

These entry modes differ in their legal form, the degree of control exercised by foreign firms, and management structure (Wei, 2003). Wei (2003) suggests that a WOE is a limited liability entity solely owned and operated by a foreign investor who receives all profits and bears all costs and risks. An international EJV is defined as a firm where resource commitment, profit distribution, risk sharing, and control and management are based on equity shares of partners rather than by contract, a feature of an international CJV (Wei, 2003). In the 1990s, a new ownership form called 'joint-stock cooperative' (JSCs, *gufen hezuozhi*) became widely adopted in China's township and village enterprise sector. JSCs are developed to avoid the excessive costs of collective decision making, to

check insider control, to mobilize internal and external finances, to diversify risk, and to facilitate further evolving.

A study from OECD (2000) suggests that during the period from 1979 to 1997 (See Table 2.12), EJVs took the lion's share of inward direct investment inflows (61.3 per cent in terms of the number of contracts and 46.0 per cent in terms of contracted amounts). WOEs took 24.7 per cent of FDI in terms of the contract number, and 30.0 per cent in terms of contracted amounts. Contractual joint ventures have been the third most important mode (14.0 per cent in terms of the numbers and 23.2 per cent in terms of the contracted amounts).

However, the entry modes of FDI into China have been changed over time. WOEs are now the fastest growing sector. During the period from 1997 to 2003 (See Table 2.14), WOEs replaced EJVs to take the lion's share of inward direct investment inflows (58.27 per cent in terms of contracted amount and 49.69 per cent in terms of realized amounts). EJVs took 27.92 per cent of FDI in terms of contracted amount and 34.56 per cent in terms of realized amounts. Contractual joint ventures have been the third most important mode (13 per cent in terms of contracted amount and 14.79 per cent in terms of realized amounts). The share of WOEs have been increasing as China implements its WTO commitments. Recent trends show that FDI tends to be more and more directed into WOEs, which accounted for more than half of total commitments since 1999 in terms of contracted amounts.

Table 2.12 Number of Entry Modes of FDI in China for Contracted FDI, 1979-1997

Entry mode	1979-1989	1990	1991	1992	1993	1994	1995	1996	1997
EJVs	38.7	41	50.8	50.1	49.5	48.6	43.5	43.5	40.6
CJVs	41.9	19	17.8	22.8	22.9	24.6	19.5	19.5	23.7
WOEs	9.7	37.1	30.6	27	27.3	26.5	36.9	36.6	34.6
Others	9.7	2.9	0.8	0.1	0.3	0.3	0.1	0.4	1.1
%	100	100	100	100	100	100	100	100	100

Source: MOFTEC, 2000; OECD, 2000.

Table 2.13 Entry Modes of FDI in China, 1997-2003

Year	Type	EJV	CJV	WOE	JSC	%
1997	Contracted	40.96	23.85	34.9	0.3	100
	Realized	43.42	19.89	36.05	0.64	100
1998	Contracted	33.23	22.4	41.81	2.56	100
	Realized	40.55	21.48	36.4	1.56	100
1999	Contracted	32.86	16.54	50.35	0.25	100
	Realized	39.67	20.64	38.96	0.73	100
2000	Contracted	31.55	13.04	55.1	0.31	100
	Realized	35.56	16.35	47.76	0.32	100
2001	Contracted	25.35	12	62.17	0.47	100
	Realized	33.96	13.4	51.5	1.14	100
2002	Contracted	22.37	7.52	69.22	0.89	100
	Realized	28.57	9.64	60.46	1.33	100
2003	Contracted	22.18	6.5	70.97	0.34	100
	Realized	29.07	7.25	63.06	0.62	100

Source: China Statistical Yearbook various issues; caculated by the author.

Table 2.14 Entry Modes of FDI in China, 1997-2003

Type	Contracted amounts	Realized amounts
EJV	27.92	34.56
CJV	13.00	14.79
WOE	58.27	49.69
JSC	0.80	0.95
%	100	100

Source: China Statistical Yearbook various issues; caculated by the author.

2.6.2 Major Theories on Choices of Entry Modes

There has been increasing interest by researchers to understand how firms choose between different entry modes. Most of the past studies on MNEs' choices of entry modes strategies have focused on three main schools of thought: 1) gradual involvement, 2) transaction cost; and 3) location-specific factors (Pan and Tse, 2000).

(1) Gradual Involvement

The first approach views business operations in overseas markets as inherently risky, and advocates a gradual involvement in the foreign market. This first school advocates a gradual involvement in the foreign market as it views business operations in an overseas market as inherently risky, due to the different political, cultural, and market systems that the firm must adapt to (Johanson and Vahlne, 1977, 1990; Root, 1987). When the first entry is made into an overseas market, a low resource commitment mode like export is desirable (Pan and Tse, 2000). Under the gradual involvement theory, Hennart and Larimo (1998) suggest that national culture is an important determinant of entry mode, which could influence the entry mode choice in two possible ways: 1) foreign investors from a country of high power distance and high uncertainty avoidance would tend to choose full control over subsidiaries in the host country; 2) foreign investors of the home countries with more cultural distance from the host country would tend to choose more partial control over their subsidiaries in the host countries .

A firm's level of commitment to invest in a foreign country is an increasing function of the knowledge of the country (Zhang and Yu, 2004). With the increasing business experience and knowledge of the host market, a foreign investing firm gradually develops the ability of operating the entry mode from export to WOEs in the host country (Chu and Anderson, 1992; Delios and Beamish, 1999; Zhang and Yu, 2004). Therefore, this perspective often describes a gradual incremental involvement (Pan and Tse, 2000).

(2) Transaction Cost

The second school of thought considers business operations from the perspective of transaction costs (e.g. Caves, 1982; Anderson and Gatignon, 1986; Beamish and Banks, 1987; Williamson, 1987; Erramilli and Rao, 1993). Under the transaction cost theory, the most appropriate entry mode is a function of the trade-off between control and the cost of resource commitment (Anderson and Gatignon, 1986). The basic concept is that firms will internalise those activities that they can perform at a lower cost, but will subcontract those activities externally if other providers have cost advantages (Pan and Tse, 2000).

Pan and Tse (2000) suggest that the transaction cost theory has found an extensive application in explaining how U.S. firms enter and operate in foreign markets (Gatignon and Anderson, 1986; Agawal and Ramaswami, 1992; Eramilli and Rao, 1993), despite the reservations of some scholars who see the theory as having weaknesses (e.g. Ghoshal and Moran, 1996).

Other research related to entry mode by transaction cost theory is by Nocke and Yeaple (2004). The authors suggest most FDI takes the form of cross-border acquisitions when factor price differences between countries are small, whereas greenfield investment plays a more important role for FDI from high-wage into low-wage countries.

(3) Location-specific Factors

The third school of thought emphasizes the importance of location-specific factors (Franko, 1971; Hill et al., 1990). Mudambi and Mudambi (1999) note that a number of factors have been shown to affect the mode of entry decision including industrial specific, firm-specific and location specific factors which are involved. Dunning (1988) emphasizes that location-specific factors are becoming more significant in affecting a firm's international operations, and that these factors have an increasing impact on the non-production related costs in terms of transaction costs. Pan and Tse (2000) suggest that location-specific factors are important in today's global competing where non-production costs are rising faster than production costs.

In the case of China, the eclectic paradigm highlighted location specific advantages as being essential to some foreign firms performing in China because different locations, such as SEZs and OCCs or other industrial zones, are associated with different investment incentives, infrastructure, and business environments.

In summary, the choice of entry mode is an important decision to MNE's international operations, allowing them to utilize their core competencies, to maintain control over subsidiaries, and to minimize their vulnerability to external changes in a host country.

The determinants of FDI entry modes can be categoried into three areas: gradual involvement, transaction cost, and location advantages.

2.6.3 Determinants of Entry Modes of FDI in China

Existing studies (e.g. Davidson, 1987; Eiteman, 1990; Gomes-Cassares ,1990; Pan, 1996; Tse et al., 1997; Pan and Li, 2000; Jiang et al., 2001; Shi et al., 2002; Gaba et al., 2002; Chen and Chen, 2002; Wei and Liu, 2004; Zhang et al., 2005) suggest that the determinants of entry modes of FDI in China tends to focus on the timing of entry, a host country experience, firms size, country-specific factors, government law and policy, the amount of foreign investment, the specific industrial location, cultural distance, industry-specific factors, etc.

Firm size is a major determinant of the entry mode of FDI in China. Empirical studies confirm that there is a positive relationship between the size of firm and the characteristics of EJVs. Empirical studies (Pan and Li, 2000; Chen and Chen, 2002) show that very large firms are more likely to have a higher equity stake in their EJVs, seek alignment with other foreign firms, engage in global industries, and are more likely to invest in large-scale EJVs than smaller firms. Large firms are also less affected by the risk conditions of the host country. Pan and Li (2000) suggest that interesting differences also exist among firms that are based in the US, Japan, and Europe.

Gomes-Cassares (1990) provides an integrated approach to explaining how MNEs select ownership structures for subsidiaries. Gomes-Cassares (1990) asserts two important results: (1) ownership structures are determined by negotiations with the host government, and the outcome depends on the MNE's bargaining power; (2) relatively large firms, and firms with high intra-system sales, are more deterred by government ownership restrictions.

Empirical results from Gaba et al. (2002) based on entry information of US Fortune 500 firms in China between 1979 and 1996, show that larger firms with a greater level of

internationalization and scope economies are likely to enter the Chinese market earlier. In addition, non-equity modes, competitors' behaviour in the product market, and lower levels of country risk are significantly associated with early entry.

Tse et al. (1997) suggest that longer diplomatic ties between China and the investing firm's home country assume more equity-based operations including JVs and WOEs, rather than non-equity-based entry modes like exporting or licensing agreements, and that firms who choose equity-based entry modes are more likely to work with Chinese municipal governments.

Shi et al. (2002) follow an eclectic approach to investigate the foreign market entry strategies of small firms from Hong Kong. They argue that previous researches focused on large corporations from developed countries and tackled the issue of entry mode from a single theoretical perspective. This article, however, develops a framework that integrates strategic, firm-specific, location-specific, and transaction-specific variables, and redresses the topic of entry mode selection by Hong Kong. This research shows that the entry selection of small Hong Kong firms is determined mainly by strategic, firm-specific, and location-specific variables, however, firm-specific ownership advantages are less important (Shi et al., 2002).

Existing studies (e.g. Jiang et al., 2001; Zhang et al., 2005) agree firms' entry mode decisions may be heavily influenced by a host country's investment policies. Joint ventures, for instance, are popular in China because there are direct and indirect government rules requiring them to act in a particular way in specific circumstances. (Davidson, 1987; Eiteman, 1990; Jiang et al., 2001). For example, at the beginning of the reform era, only joint ventures (JVs) were officially accepted as a means of investment, according to the Sino-Foreign Equity Joint Venture Law (NPC, 1979). After the

'experimented'[13] period, FDI was then gradually allowed into areas other than the SEZs and into a large number of industrial sectors (Wei, 2003).

Empirical findings from Pan (1996) found eleven determinants that impact on foreign ownership preferences and concessions in EJVs: 1. advertising intensity, 2. foreign capital input, 3. the country risk of China, 4. equity joint venture (EJV) investment amount, 5. EJV contractual duration, 6. cultural distance, 7. competitive intensity, 8. local partner state ownership, 9. local partner alignment, 10. foreign partner alignment, and 11. EJV location.

Another study by Pan (2002) found four determinants in the EJV in China: the exchange rate, the cost of borrowing, export capability and management orientation. Based on a sample of 8078 international joint ventures in China, Pan's (2002) study shows that EJVs tend to be higher for parent firms from a source country with a strong currency, a low cost of borrowing, strong export capability and high uncertainty avoidance.

Wei and Liu (2004) explore entry modes of foreign direct investment in China based on a multinomial logit model for choice from four FDI entry modes. Based on a sample of 10607 foreign invested firms in China, Wei and Liu (2004) study finds: 1) A MNE's choice of the WOE mode is positively associated with its large investment commitment, a good industrial location, the host-country experience in attracting FDI, and a high asset intensity in the host country; 2) If the conditions of the host country experience and good specific location are not met, foreign investors will prefer to use the EJV and the JSC modes as WOE and EJV modes are positively associated with the asset intensity of the host country; 3) A good specific location, such as coastal areas, also makes the CJV a preferable entry mode; 4) Compared with the overseas Chinese investors from Hong

[13]Wei (2003) suggests that China in the early years since 1978 could be seen to have been experimental with FDI because the bulk of it was concentrated in the four SEZs, in the Guangdong and Fujian provinces, and foreign enterprises' participation was confined to joint ventures (JVs) and export-oriented activities.

Kong, Macao and Taiwan, other foreign investors prefer EJVs over WOEs and CJVs (Wei and Liu, 2004).

In summary, empirical results suggest that entry modes of FDI may vary by country, industry and firm-specific factors.

2.7 Conclusion

This chapter provides a review of the existing literature in FDI flows into China so as to provide an overview of FDI status in China in order to place my study into perspective. This chapter also explores the scale of China's round tripping FDI and reviews the cause and implications of China's round tripping FDI.

There has been an increasing amount of literature dealing with various dimensions of the characteristics, trends and determinants of FDI flow in China in the past two decades. China in recent years has emerged as the largest recipient of FDI in the world. Existing studies agree that China's high economic growth has been supported by the Open Door Policy to introduce FDI. The major features of China's FDI policy are: geographic opening, a selective FDI policy, special treatment for overseas Chinese creating SEZs, strong leaderships in promoting FDI from export promotion to an open domestic market.

The characteristics of inward FDI in China include: the uneven development of FDI, the statistical bias in the volume of FDI, the statistical bias of FDI by nationality of source countries, the uneven sectoral distribution of FDI and regional bias. A significant portion of FDI flows into China originated from China's neighbouring regions, such as Hong Kong and Taiwan. These investors are SMEs, and they operate simple and labour-intensive production and assembly processes (Huang, 2003). Three major characteristics have been identified with the significant Hong Kong FDI flows in China (Fung, 1996; Chen, 1997; Lemoine, 2000; Wei, 2003), including political consideration, two-stage investment, and the round-tripping problem.

The motives for FDI in China vary by source countries and firm size and may change over time. The determinants of FDI can be broadly categorised into two groups: studies at national level and those at regional level (Wei, 2003). Existing literature suggests that the common determinants at regional level include market size, agglomeration effects, infrastructure, labour quality, labour costs and FDI incentives. The literature reviews found that the determinants of FDI at national level include market size, labour cost, labour quality, FDI policies, cultural difference and exchange rates, which could all facilitate or deter investment inflows. Existing empirical results suggest that entry modes of FDI may vary by country, industry and firm-specific factors.

Taking these features of China's inward FDI together suggests that FDI has played a more important role in the Chinese economy than many analysts have realized. The unique features indicate that the dynamics of FDI in China may be different from those in other countries.

Chapter 3 TDI in China

3.0 Introduction

China, as the world's potential largest market, has emerged as a vital economic and political power in the Asian Pacific. For Taiwan, China has provided a ready and convenient market for its manufactured goods and capital, which it is increasingly becoming reliant upon to further its economic development (Feng, 2002). The shortest distance from Taiwan to China is only 110 miles. Confronting the attraction of the Chinese market and the challenge from the deteriorating investment environment in Taiwan, Taiwanese firms have increasingly been rushing into China since the end of 1980s. After the admittance of China and Taiwan into the WTO, more Taiwanese firms relocated some of their production facilities to China (Lin and Ling, 2003).

FDI in the Asian New Industrialized Countries (NICs), including Taiwan, have received considerable attention, although much less is known about recent Taiwanese direct investment (TDI) (Schive, 1990; Guiheux, 1998). Hou (2002)[14] also argues that there is a growing literature on the determinants of aggregate FDI flows in China (e.g. Cheng and Kwan, 2000a, 2000b; Tseng and Zebregs, 2002; Chen and Chen, 2002; Shi et al., 2002; He, 2003a, 2003b; Zhang et al 2004; Wei and Liu, 2004), but studies on TDI in China have been limited.

Relations between Taiwan and China are paradoxical and contentious. This chapter will first review current Taiwan and Chinese economic relations and the trade policy regarding cross-Strait trade and investment, and then will follow this with an analysis of the motives, characteristics, entry modes and determinants of TDI in China in order to put

[14] Hou's working paper was listed at the Center for Economic Development as a 2002 version. But, having contacted Dr Hou to inquire if there was any further update on this paper, he said that he last worked on it in 2004. Dr. Hou emailed me a copy of his working paper, version 2004, on January 7, 2005 when he was back from his New Year holidays.

my present study into perspective. The subcontract system, a major motive for TDI, will be explored in chapter 4 and the political considerations regarding TDI in China will be explored in chapter 5 as more complicated issues are involved concerning these two topics.

3.1 An Overview of Economic Relations with China

Taiwan economic relations with China have been steadily liberalized in recent years. Although it has received limited attention, trade and investment are among the few bright spots in the Taiwan-China relationship. Despite the constant threat of conflict, economic ties have dramatically increased over the last two decades. This section aims to provide an overview of Taiwan's economic relations with China, which include: 1) statistics on cross-Strait trade; 2) an overview of the TDI status; 3) the impact of TDI into China on Taiwan's domestic economy; and 4) policy and regulations.

3.1.1 Statistics on Cross-Strait Trade

From an economic perspective, cross-Strait economic relations are asymmetric (Leng, 1998). Since the opening of legal indirect trade and investment in 1987, Taiwan has enjoyed a large trade surplus with China. At the same time, shares of exports to China in Taiwan's total exports have also been on the rise from US$425.5 million in 1984 to US$44,960.4 million in 2004. In 2003, China became Taiwan top trading partner, even without a direct cross-Strait transportation link. Table 3.1 shows the evolution of Taiwan's economic dependence on China. These rates would be even higher if trade through Hong Kong was included. Leng (1998) suggests that China's export dependence on Taiwan, however, is relatively small.

A dissented view from Hou (2002) suggests that such surplus is simply a result of relocating assembly plants from Taiwan to China, mostly for labour-intensive production. By and large, Taiwanese firms in China have tried to integrate their Chinese production networks with their parent companies in Taiwan by centralizing the strategic decision-making and high value-added activities in Taiwan. Under this circumstance, local linkage

has remained limited, and most components and materials imported from Taiwan. Hou (2002) suggests that two indicators reveal these kinds of investment patterns: i) Taiwanese firms in China have relied much more on component imports from Taiwan than similar affiliates in North America and Europe; ii) Component exports are by far and away the main cause for Taiwan's huge trade surplus with China.

Table 3.1 shows that the most significant feature is the large and growing trade surplus of Taiwan. However, the huge Taiwanese exports are mainly mid-products used for final assembling stages of production and equipment. As a large portion of the final products is re-exported to third markets (mostly the USA and Japan), Taiwan has switched its trade surplus from the USA and Japan to China. For example, China's trade surplus with the USA rose substantially in the 1990s. Therefore, the fact that China now accounts for a higher share of Taiwan's exports than the USA is partly due to this export transfer effect (Wang, 2004). Hou (2002), therefore, suggests that China's export dependence on Taiwan is much larger than the estimates from official statistics show.

Hou (2002) asserts that Taiwan's export to these TDI subsidiaries in China far exceeds the estimates from the official sources. Apart from supplying the raw material and mid-products to these TDI subsidiaries in China, the parent companies in Taiwan also provide (or export) marketing/sales services and production technology supports. MOEA (1999) showed that 68% of parent companies provided marketing services for their TDI subsidiaries, and 92% provided production techniques to the subsidiaries. MOEA (2000) showed an even more interesting set of statistics. The percentage of *Taiwan jiedan, dalu chukou* was 26.3%, which represents a unique model whereby orders are received in Taiwan but production takes place in China, and so goods which are shipped from China has gradually taken shape (Wang, 2004).

Table 3.2 shows the indirect trade between China and Taiwan from 1989 to 2005 from different official sources. These statistics of indirect trade between China and Taiwan are significantly different because many Taiwanese firms trade with China via a third area to comply with the Taiwanese government's trade restraints with China.

Table 3.1 Estimation of Trade between Taiwan and Mainland China, 1984-2005

Unit: US$ million

	A	B1	B2	B1-B2	C			
Period	Taiwan Exports Mainland China	Taiwan Exports HK (F.O.B.)	HK. Imports from Taiwan (C.I.F.)	Difference between (2) and (3)	Transit trade from Taiwan to Mainland China via HK	Estimation of Taiwan Exports to Mainland China	Taiwan Imports from Mainland China	Estimation of Total Indirect Trade between Taiwan and Mainland China
1984	–	2,087.1	2,217.5	-130.4	425.5	425.5	127.8	553.3
1985	–	2,539.7	2,682.4	-142.7	986.8	986.8	115.9	1,102.7
1986	–	2,921.3	3,072.8	-151.5	811.3	811.3	144.2	955.5
1987	–	4,123.3	4,275.1	-151.8	1,226.5	1,226.5	288.9	1,515.4
1988	–	5,587.1	5,682.4	-95.3	2,242.2	2,242.2	478.7	2,720.9
1989	–	7,042.3	6,606.9	435.4	2,896.5	3,331.9	586.9	3,918.8
1990	–	8,556.2	7,439.9	1,116.3	3,278.3	4,394.6	765.4	5,160.0
1991	0.1	12,430.5	9,605.0	2,825.5	4,667.2	7,493.5	1,125.9	8,619.4
1992	1.1	15,415.0	11,156.3	4,258.7	6,287.9	10,547.6	1,119.0	11,666.6
1993	16.2	18,452.6	12,047.2	6,405.4	7,585.4	13,993.1	1,103.6	15,096.7
1994	131.6	21,262.3	13,757.7	7,504.6	8,517.2	16,022.5	1,858.7	17,881.2
1995	376.6	26,105.9	16,572.6	9,533.3	9,882.8	19,433.8	3,091.4	22,525.2
1996	623.4	26,787.6	15,795.1	10,992.5	9,717.6	20,727.3	3,059.8	23,787.1
1997	626.5	28,688.1	15,967.6	12,720.5	9,715.1	22,455.2	3,915.4	26,370.6
1998	834.7	24,619.7	13,342.9	11,276.8	8,364.1	19,840.9	4,110.5	23,951.4
1999	2,536.9	26,012.1	12,875.2	13,136.9	8,174.9	21,312.5	4,522.2	25,834.7
2000	4,217.5	31,336.3	15,919.5	15,416.8	9,593.1	25,009.9	6,223.3	31,233.1
2001	4,745.4	26,961.4	13,837.0	13,124.4	8,811.5	21,945.7	5,902.2	27,847.9
2002	9,951.8	30,858.5	14,920.3	15,938.2	10,322.6	29,465.0	7,947.7	37,412.5
2003	21,417.3	28,353.6	16,051.7	12,301.9	11,789.4	35,357.7	10,962.0	46,319.7
2004	34,046.7	29,875.1	19,719.5	10,155.6	14,761.9	44,960.4	16,678.7	61,639.1
2005								
Jan.-Feb.	5,540.1	4,257.4	2,932.5	1,324.9	2,234.5	7,006.3	2,777.0	9,783.3
Feb.	2,296.1	1,716.3	1,211.4	504.9	935.7	2,878.0	1,088.8	3,966.8

Source:(A) and (B1) are from Taiwan Customs Statistics, (B2) and (C) are from Hong Kong Customs Statistics.

Note:

1. A negative figure in column (B2-B1) will be treated as zero.

2. ** used Hong Kong Customs statistics before 1993; has changed to Taiwan Customs statistics since 1994.

3. Before 2001 the estimation method of the Mainland Affairs Council (MAC)was used as: (B1-B2)+C.But since 2002 MAC and the Board of Foreign Trade (BOFT) decided to change the formula and switch to A+(B1-B2)*80%+C-r*A.

4. "r" presents the average ratio of the import from Taiwan in Guangdong to all in China according to China Customs Statistics. Now the "r" is 36% from 1999 to 2002.

Table 3.2 Statistics of Indirect Trade between Taiwan and China, 1985-2005

Unit: US$million

	Hong Kong Customs Statistics			Taiwan Customs Statistics			Mainland China Customs Statistics			Estimation by Mainland Affairs Council, Taiwan		
Period	Exports	Imports	Total	Exports	Imports	Total	Exports	Imports	Total	Exports	Imports	Total
1989	2,896.5	586.9	3,483.4	–	–	–	–	–	–	3,331.9	586.9	3,918.8
1990	3,278.3	765.4	4,043.6	–	–	–	2,255.0	319.7	2,574.6	4,394.6	765.4	5,160.0
1991	4,667.2	1,126.0	5,793.1	–	597.5	597.5	3,639.0	594.8	4,233.9	7,493.5	1,125.9	8,619.4
1992	6,287.9	1,119.0	7,406.9	1.1	747.1	748.1	5,881.0	698.0	6,579.0	10,547.6	1,119.0	11,666.6
1993	7,585.4	1,103.6	8,689.0	16.2	1,015.5	1,031.7	12,933.1	1,461.8	14,394.9	13,993.1	1,103.6	15,096.7
1994	8,517.2	1,292.3	9,809.5	131.6	1,858.7	1,990.3	14,084.8	2,242.2	16,327.0	16,022.5	1,858.7	17,881.2
1995	9,882.8	1,574.2	11,457.0	376.6	3,091.4	3,468.0	14,783.9	3,098.1	17,882.0	19,433.8	3,091.4	22,525.2
1996	9,717.6	1,582.4	11,300.0	623.4	3,059.8	3,682.7	16,182.2	2,802.7	18,984.9	20,727.3	3,059.8	23,787.1
1997	9,715.1	1,743.8	11,458.9	626.5	3,915.4	4,543.2	16,441.7	3,396.5	19,838.2	22,455.2	3,915.4	26,370.6
1998	8,364.1	1,654.9	10,019.0	834.7	4,110.5	4,945.2	16,629.6	3,869.6	20,499.2	19,840.9	4,110.5	23,951.4
1999	8,174.9	1,628.1	9,803.0	2,536.9	4,522.2	7,061.7	19,537.5	3,951.7	23,489.2	21,312.5	4,522.2	25,834.7
2000	9,593.1	1,980.5	11,573.7	4,217.5	6,223.3	10,440.8	25,497.1	4,994.9	30,492.1	25,009.9	6,223.3	31,233.1
2001	8,811.5	1,693.3	10,504.8	4,745.4	5,902.2	10,647.8	27,339.4	5,000.2	32,350.0	21,945.7	5,902.2	27,847.9
2002	10,311.8	1,708.1	12,019.8	9,945.0	7,947.7	17,892.8	38,063.1	6,585.9	44,649.0	29,465.0	7,947.7	37,412.5
2003	11,789.4	2,161.1	13,950.4	21,417.3	10,960.5	32,377.8	49,362.3	9,004.7	58,367.0	35,357.7	10,962.0	46,319.7
2004	14,761.9	2,485.4	17,247.3	34,046.7	16,681.6	50,728.4	64,778.6	13,545.2	78,323.8	44,960.4	16,678.7	61,639.1
2005												
Jan.-Feb.	2,234.5	354.2	2,588.7	5,540.1	2,777.1	8,317.1	9,386.0	2,094.3	11,480.3	7,006.3	2,777.0	9,783.3
Feb.	935.7	139.9	1,075.6	2,296.1	1,088.8	3,384.9	4,315.3	952.1	5,267.4	2,878.0	1,088.8	3,966.8

Note: Exports indicate the amount of exportation from Taiwan to Mainland China, and Imports indicate the amount of importation from Mainland China to Taiwan.

Source: Monthly Statistics of Exports of Cross-Straits Economic Statistics, the Mainland Affairs Council, Taiwan, 2005.

3.1.2 An Overview of the TDI Status

The previous section notes rising Taiwan's trade dependence on China. Similarly, TDI has also been concentrated in China since the mid-1990s. This section provides an overiew of the TDI status.

Taiwanese policy towards TDI has also undergone changes over time. Before 1978, outward TDI was under relatively rigid financial requirements, which laid down for the qualification of TDI and offered virtually no incentives. The Taiwanese government relaxed the financial requirements restrictions on outward TDI due to the worldwide recession and energy crisis in the 1970s (Kumar, 1995). Therefore, since the end of the 1970s, Taiwanese companies have started to invest abroad, and this trend has accelerated during the last twenty years.

Till the mid-1980s, TDI made by Taiwanese companies was quite modest. These included 123 investments made up to 1978 with a total investment of US$50 million and 50 investments made between 1979-1984 with an investment of US$ 84 million. Since the mid 1980s, Taiwan has accumulated significant foreign exchange reserves and has enjoyed its current account surpluses. This has led to an appreciation of New Taiwan $ vis-à-vis US$. Between 1986 and 1992 alone NT$ had appreciated by nearly 40 per cent against US$. The enormous foreign exchange reserves also led to inflationary tendencies within the economy (Chaponniere, 1992; Kumar, 1995).

In the 1980s the Taiwan currency was under strong pressure of appreciation due to the rapid accumulation of foreign reserves. The industrial wages increased substantially in late 1980s with a serious labour shortage (Hou, 2002; Wu, 2000). All these factors put together undermined the international competitiveness of Taiwan, especially in labour intensive goods which were its traditional exports. Under these circumstances, Taiwanese

enterprises started moving production to Southeast Asia and China to take advantage of the cheap labour availability. Remittance for financing outward investment has been less strict since 1987 (Wu, 2000). In 1987, the Taiwanese government assisted in outward TDI by further relaxing the controls on capital outflow, allowing remittance of up to US$5 million a year out of the country. This explains a sudden jump in the FDI approvals since 1987 (Taiwan, MOEA, 1993; Kumar, 1995; Lin and Liang, 2003).

Therefore, during the 1980s, faced with challenges at home, including labour shortages, the appreciation of the New Taiwan dollar, the high price levels of real estate, and an environmental protection movement, many Taiwanese firms have been striving to internationalize their operations, both in Asia, North America, and Europe (Guiheux, 1998).

The locational patterns of TDI within the world have drastically changed because of "China fever" over the last few years (Gupta, 2003). At the end of the 1970s, the great majority of TDI (70.8%) was directed towards South East Asia, whereas 16.5% was invested in North America. Ten years later, in 1988, the situation was almost reversed: North America took the lion's share of 60% and Southeast Asia took 30% of TDI. Following the legalization of Taiwan's investments to China in 1991, Asia bounced back as the first destination with 61% of TDI. In the 1990s, Taiwan had become among the very first investors in several Asian countries: second in China and in Malaysia, first in Vietnam, etc. In 1995, the dominant position of Southeast Asia had been reduced to 13.31% of the total approved TDI. In 2002, China had received 53.38% of total approved outward TDI. The share of Southeast Asia had been reduced to only 2.92% of the total approved TDI (Guiheux, 1998). Therefore, since the middle of the 1990s, TDI has been concentrated in China (see Table 3.3, Table 3.4, and Table 3.5)

Taiwan's Investment Commission did not compute formal statistics until 1991 (See Table 3.3; Tung, 2000). In 1991, Taiwan's FDI into China was only US$0.17 billion according to Taiwan's official figures. As shown, Taiwan's approved investment in China surpassed its investment in the United States in 1992 (Table 3.5 and Table 3.7). Since

1993, Taiwan has been the second largest investor in China, next only to Hong Kong (SSB, 1998). The approved TDI in China amounted to US$1,140 million in 1993, US$2,607 million in 2000, US$2,784 million in 2001, US$3,859 million in 2002, and US$4,595 million in 2003, seen respectively as 40.71 %, 33.90%, 38.8%, 57.6%, and 53.66 % of the total outward TDI (MOEA, 2004). Hou (2002), on the other hand, argues that Taiwan may indeed be the largest FDI, as Hong Kong FDI in China may be a form of "money laundering" or "round-tripping". The reason behind the increasing surge of TDI in China is that the Taiwanese government finally allowed TDI in China via a third country in 1990 (MOFERT, 1987-1997; Hou, 2002).

By the end of 1997, Taiwan's cumulative FDI in China was US$11.2 billion, 42% of Taiwan's total FDI. In only 7 years, China took the lion's share of the most accumulated TDI (Tung, 2000). As of the end of September 2003, the Investment Commission of the MOEA approved 30,661 investment cases in China with a total value in excess of US$32.97 billion, which shows a 294% growth rate on TDI into China, compared with the previous accumulated TDI in 1997.

In summary, since 1993, Taiwan has been China's second largest investor after Hong Kong, despite the Taiwanese government's restrictions. However, the actual level of TDI in China is greatly debated. The reasons behind the debate are that Taiwan maintains restrictions on the amount and types of investment that are allowed to be invested in China. Many Taiwanese firms seek to circumvent these restrictions by investing in China through third areas or foreign holiday companies.

Table 3.3 Approved FDI from Taiwan by the Taiwanese Government into China, 1989-2003 (Unit: US$ million)

Year	China
1989	-
1990	-
1991	174.16
1992	246.99
1993*	1,140.37 (2,028.05)

1994	962,209
1995	1,092,713
1996	1,229,241
1997*	1,614.54 (2,719.77)
1998*	1,519.21 (515.41)
1999	1,252,780
2000	2,607,142
2001	2,784,147
2002	6,723,058
2003	7,698,784

Note: Figures * ( ) means lagged approval.

Source: Investment Commission, MOEA, Taiwan, 2004

Table 3.4 Approved Taiwanese Outward FDI, 1994-2002 (unit: US$1,000)

Year	China (% on total TDI)	Southeast Asia (% on total TDI)
1994	962,209(37.31)	397,731 (15.42)
1995	1,092,713 (44.61)	326,098 (13.31)
1996	1,229,241(36.21)	587,268(17.3)
1997	1,614,542(35.81)	641,241(14.22)
1998	1,519,209(31.55)	477,494(9.92)
1999	1,252,780(27.71)	522,180(11.55)
2000	2,607,142(33.93)	389,446(5.07)
2001	2,784,147(38.80)	523,339(7.29)
2002	3,858,757 (53.38)	210,863(2.92)

Note: Southeast Asia refers to Malaysia, Singapore, Thailand, Indonesia, the Philippines and Vietnam.

Source: Hsu and Liu, 2004

Table 3.5 Approved FDI from Taiwan by the Taiwanese Government (excluding TDI into China), 1989-2003 (Unit: US$ million)

Year	Total	Increasing (%)	USA	Japan	Hong Kong	Singapore	Thailand
1989	930,986	325.62	508,732	335	10,372	5,209	51,604
1990	1,552,206	66.73	428,690	1,807	33,092	47,622	149,397
1991	1,656,030	6.69	297,795	3,431	199,630	12,540	86,430

1992	887,259	-46.42	193,026	5,321	54,447	8,790	83,293
1993	1,660,935	87.20	529,063	63,297	161,918	69,473	109,165
1994	1,616,764	-2.66	143,884	22,731	127,284	100,732	57,323
1995	1,356,878	-16.07	248,213	8,811	99,555	31,649	51,210
1996	2,165,404	59.59	271,329	6,798	59,927	164,978	71,413
1997	2,893,826	33.64	547,416	32,342	141,593	230,310	57,546
1998	3,296,302	13.91	598,666	29,596	68,643	158,176	131,186
1999	3,269,013	-0.83	445,081	121,867	100,318	324,524	112,665
2000	5,077,062	55.31	861,638	312,222	47,512	219,531	49,781
2001	4,391,654	-13.50	1,092,747	169,033	94,901	378,301	16,287
2002	3,370,046	-23.26	577,782	23,554	167,064	25,760	5,959
2003	3,968,588	17.76	466,640	100,371	641,287	26,403	48,989

Source: Investment Commission, MOEA, Taiwan, 2004

Table 3.6 Approved FDI into South East Countries from Taiwan by the Taiwanese Government from 1959-2004 (unit: US: million)

	Thailand		Malaysia		Philippines		Indonesia		Singapore		Vietnam		Cambodia		Total	
Year	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount	Case	Amount
1959 -1989	642	2,097.25	477	1,257.05	373	349.41	45	1,891.97	35	22.72	1	1.00	0	0	1,573	5,619.40
1990	144	782.70	270	2,347.83	158	140.70	94	618.30	10	47.60	16	251.00	0	0	692	4,188.13
1991	69	583.50	182	1,326.17	109	12.00	58	1,057.80	13	12.50	26	520.90	0	0	457	3,512.87
1992	44	289.90	137	574.70	27	9.10	23	563.30	11	8.79	27	561.60	0	0	269	2,007.39
1993	61	215.40	86	331.18	21	5.40	20	127.50	12	69.47	39	421.30	0	0	239	1,170.25
1994	88	477.50	100	1,122.76	42	267.80	48	2,487.50	19	100.73	68	518.60	2	0.57	367	4,975.46
1995	102	1,803.90	123	567.80	34	13.60	89	639.93	20	31.65	55	1,239.70	14	10.03	437	4,306.61
1996	66	2,785.20	79	310.40	22	7.40	111	534.60	54	165.00	49	534.30	34	163.73	415	4,500.63
1997	62	414.30	63	480.40	16	13.10	101	3,419.40	27	230.31	58	247.80	62	44.04	389	4,849.35
1998	69	253.60	74	263.40	19	5.41	91	157.40	56	158.18	62	440.60	25	144.26	396	1,422.85
1999	86	211.10	66	70.26	18	4.98	91	1,180.30	19	324.52	82	172.90	15	55.39	377	2,019.45
2000	120	437.41	92	241.07	10	0.97	74	131.20	40	219.53	137	280.50	15	18.85	488	1,329.53
2001	50	158.69	88	296.58	9	0.05	60	72.00	26	378.30	127	455.70	8	56.97	368	1,418.29
2002	41	62.93	64	66.29	22	234.57	28	19.31	27	25.76	189	277.00	4	6.82	375	692.68
2003	57	338.83	57	163.69	17	46.43	29	39.02	15	26.40	167	321.60	1	1.00	343	936.97
2004	53	268.53	79	117.31	11	29.52	40	42.21	18	822.23	159	469.57	6	4.60	366	1,753.97
Growth rate		-20.74		-28.33		-36.42		8.17		3,014.51		46.01		360.00		84.78
Accu-mulated	1,754	11,180.74	2,037	9,536.89	908	1,140.44	1,002	12,981.74	402	2,643.69	1,262	6,714.07	186	506.26	7,551	44,703.83
Rate on FDI in	3		3		7		6		N.A.		2		2		N/A	

host country								

Source: Industrial Development & Investment Centre, Ministry of Economic Affairs, Taiwan, 2005.

Table 3.7 Taiwanese Direct Investment in China, 1991-2004 (Unit: US$100 million)

Approved Ministry of Economic Affairs (MOEA), Taiwan					Official data from China		
Period	Cases	Amount	Average amount	% on total TDI	Projects	Contracted amount	Realized Amount
1991	237	174	0.7348	9.52	3,884	35.37	11.05
1992	264	247	0.9356	21.78	6,430	55.43	10.5
1993*	1,262 (8067)	1140 (2028)	0.9033	40.71	10,948	99.65	31.39
1994	934	962	1.0302	37.31	6,247	53.95	33.91
1995	490	1093	2.23	44.61	4,778	57.77	31.62
1996	383	1229	3.2095	36.21	3,184	51.41	34.75
1997*	728 (7,997)	1615 (2720)	2.2178	35.82	3,014	28.14	32.89
1998*	641 (643)	1519 (515)	2.3697	31.55	2,970	29.82	29.15
1999	488	1253	2.5672	27.71	2,499	33.74	25.99
2000	840	2607	3.1036	33.93	3,108	40.42	22.96
2001	1186	2784	2.3474	38.8	4,214	69.14	29.79
2002*	1,490 (3,950)	3859 (2864)	2.5899 0.7251	53.38	4,853	67.41	39.71
2003*	1,837 (8,268)	4595 (3104)	2.5008	53.66	4,495	85.58	33.77
2004 (Jan-Mar)	554	1292	2.3321	67.43	-	-	7.81
Total	31,705	356			60,624	707.83	375.29

Note:

1. Figures included lagged reports from July 2002 to July 2003 and approvals.

2. Figures * ( ) means lagged approval.

Source: Investment Commission, MOEA, Taiwan, 2004, April.

3.1.3 The Impact of TDI into China on Taiwan's Domestic Economy

The effect of the TDI into China on the Taiwan domestic economy and domestic industries is a subject of continuous debate (Hsu and Liu, 2004) although cross-Strait economic relations seem to provide a solution in decreasing political tensions between China and Taiwan.

A growing numbers of various analysts, commentators and policymakers in Asia, including Taiwan, have voiced concerns about the emergence of China and the fact that China is adversely affecting direct investment flows into their economies (Chantasasawat et al., 2004a). For example, In November 2002, Singaporean Deputy Prime Minister Lee Hsien Loong also commented that "Southeast Asian countries are under intense competitive pressure, as their former activities, especially labour-intensive manufacturing, migrate to China. One indicator of this massive shift is the fact that Southeast Asia used to attract twice as much FDI as Northeast Asia, but the ratio has reversed" (ChinaOnline November 14, 2002). The Taiwanese government has implemented the "go south" policy to encourage Taiwan to switch TDI from China to Southeast Asian countries by facing the rapid growth of the Mainland Chinese economy (Taiwanese Central News Agency November 21, 2002; Wu, 1997; Chantasasawat et al., 2004a).

Using the firm-level data taken during 1986 to 1994, Chen and Ku (2000) found that TDI would strengthen rather than weaken the viability and competitiveness of domestic industries. Lin and Liang (2003) suggest that according to the principle of comparative advantage: 1) Taiwanese firms could locate such activities as production supply-chain and distribution in China to take advantage of the first-mover; 2) They have to strengthen their core competencies and increase their operation scale; 3) They could adopt a strategic alliance strategy in terms of CJVC to cooperate with partners in China to gain mutual benefits. Therefore, Lin and Liang (2003) assert that TDI inflows into China may strengthen Taiwanese competitiveness in export markets and achieve the scale of economy.

However, Wu (1997) found that increasing TDI flows into China has had a major effect on Taiwan's industrial structure. For instance, Wu (1997) points out that 80 per cent of Taiwan's shoe industry has been transferred to the mainland. A recent study by Chen (2003) warns of the risk of the Taiwanese domestic industrial hollowing-out effect for TDI flows into China, which includes 1) FDI-induced exports decreased over time as a result of localization; 2) Logistics functions as the headquarters continue to shift abroad; and 3) R&D activities increased in China, leading to technology outflow and a brain drain. Another recent study by Hsu and Liu (2004) shows that domestic production and investment in Taiwan were shrunk over time. Hsu and Liu (2004) warns of the expansionary outward FDI from Taiwan into China, which may cause a hollowing-out of Taiwanese domestic industries.

Another recent study by Chen and Ku (2003) explores the effect of FDI on domestic employment by examining the data of Taiwan's manufacturing industry. Important findings for this study are: 1) Firms that have engaged in TDI do not have employment growth in Taiwan; 2) Firms that have engaged in TDI have a higher probability of survival than those who have not; 3) The magnitude of the employment effect arising from TDI differs across the labour groups. Technical workers tend to benefit most from TDI, followed by managerial workers, and blue-collar workers who seem to benefit the least from TDI and may even be affected adversely; and 4) Firms that invest only in China contribute the least to the expansion of domestic output, followed by firms that invest only outside of China, and TDI covering both China and other regions is most conductive to output expansion at home (Chen and Ku, 2003).

Wang (2004) suggests that early studies of the TDI operations in China, such as those by the Chung-Hua Institution for Economic Research (1993, 1994), Kao Hsi-chun and Lin Tsu-chia (1993) and the Chinese Professional Management Association (1995) find 1) the majority of Taiwanese firms investing in China continued to maintain their Taiwan operations; 2) The relationship between the Mainland subsidiary and the Taiwan parent company was usually a close one; and 3) The important decisions were made in Taiwan's headquarters, particularly regarding the purchasing of important machinery, the provision

of production technology support, the cultivation of management, and the establishment of export marketing systems. These previous studies found the parent companies in Taiwan played a very important role in the operations of their Chinese subsidiaries.

On the other hand, China's FDI policy also plays a significant role in this process of relationship change between parent companies in Taiwan and subsidiaries in China. Kao (2001) and Wang (2004) assert that this relationship has changed over time because of a growing trend towards localization. The reasons behind this change are China's FDI incentives and China's WTO entry. For example, recently the Chinese government has been encouraging foreign enterprises to increase the scale of their purchasing in China. Those companies that purchase production equipment made in China can obtain a refund on value added tax (VAT), and can also obtain exemption from corporate income tax.. There is a close relationship between Taiwan's trade structure and industrial upgrading. China's economy has been growing at an extremely rapid pace since the Open Door Policy launched in 1978. And, China's WTO entry in 2001 helped to open its domestic market. This in turn has speed up the TDI's localization in China. In other words, TDI has been changed from resource-seeking FDI to market-seeking FDI because of China's WTO entry. The trend towards localization is, therefore, raising concerns in Taiwan, and it implies that the relationship between Taiwanese parent companies and their subsidiaries in China will have to change.

Despite considerable concerns that an increase in FDI flow to China is at the expense of other regional economies, a recent empirical study by Chantasasawat et al. (2004a) also shows that other Asian economies can actually benefit from FDI into China. There is a close relationship in production networks among Asian countries and the increased resource demand by a growing China. The evidence for the production can be found in the substantial two-way trade of intermediate and final goods in the same industries among those countries. This study asserts the China effect is in general not the most important factor determining the inflows of FDI into Asian or Latin American economies. Chantasasawat et al. (2004a) conclude that market size variables and policy variables

such as the lower corporate taxes and higher degrees of openness, play larger roles in attracting investment.

In summary, it is arguable whether TDI in China impacts on the Taiwanese domestic economy although the Taiwanese government and some scholars warn of the hollow-out effect. TDI has been concentrated in China since the middle 1990s and there is an argument that investment in China is potentially more harmful to domestic employment than FDI in the other regions, particular to blue-collar labour groups (Chen and Ku, 2003). The argument may remain because of the cultural proximity and similarity in labour skills, and cause a strong substitution effect in domestic employment.

3.1.4 Policy and Regulations

The Taiwanese government takes the issue of Taiwanese Mainland-based investment very seriously and is wary of too much economic dependence on China. This section further explores major policy and regulations on TDI into China.

(1) The Evolution of Taiwan's Mainland Economic Policy

The Taiwanese policy towards outward FDI in China has undergone changes over time. The most significant feature of Taiwan's Mainland policy is that national security is still a priority with regard to economic links. This has become a main concern for Taiwan's Mainland economic policy due to Taiwan's high trade dependence on China (Leng, 1998; Gupta, 2003). For example, China accounted for approximately 12.1 per cent of Taiwan's total trade volume in 2001 (17.90 per cent and 5.5 per cent of Taiwan's exports and imports, respectively). An increasing relocation of Taiwan business to China prompted the Taiwanese government to adopt a "patience over haste *(jieji yongren)*" policy on Mainland-based investments in 1996 (Gupta, 2003). The *jieji yongren* policy was promoted by President Lee in 1996, which aims to discourage the growing TDI into China and regulate Taiwanese investments of big enterprises and high-tech industries in China..

In May 1997, the Ministry of Economic Affairs (MOEA) released a set of new criteria for rating "special case" categories of investment projects. The major criteria include: i) If the industry is labour-intensive and less competitive in the international market, the chance of being approved for investment in China is higher; ii) Approval is more likely if firms have more investments in Taiwan's domestic market and international market than in China, or have accumulated investment capital from the international market rather than Taiwan's domestic market; iii) New criteria have set the ceiling for any single investment project at US$50 million (Leng, 1998). This reveals that national security is still a priority with regard to economic links.

Despite this concern, however, the *jieji yongren* policy was later replaced in November 2001 with a more liberalized policy of "dynamic liberalization with effective management (*jijikai fang youxiao guanli*)" (Gupta, 2003; Siu et al., 2003). As increasing pressure from Taiwanese industries has occurred, Taiwan's President Chen has endorsed the recommendations by the Economic Development Advisory Conference to change the policy on cross-Strait economic relations (Gupta, 2003). Essentially, Taiwan business can now directly invest in China without going to a third place, although each project has to get approval from the government under some restraints set on the amount and types of the investment projects that Taiwanese firms can engage with in China (Siu et al., 2003). The major initiatives include (Gupta, 2003): a) Promoting the development of cross-Strait economic interactions; b) The changing of the "no haste, be patient" policy to an "active opening, effective management"; c) Allowing Mainland investment into Taiwan; d) The lifting of the ban on direct links; e) Restoring cross-Strait negotiations. Under this new policy, some of the famous Taiwanese companies are making significant investment in China, including Uni-President Enterprise (NT$12.7 billion)[15], Chi Mei (NT$1.5 billion) and FPG (NT$5.7 billion) (Gupta, 2003).

[15] Uni-President Enterprise is the biggest food group in Taiwan with its powerful 7-11 food retailing stores.

In summary, the Taiwanese government has gradually released restrictions on TDI into China. To some extent, Taiwan's economic policies toward China have been mainly due to the political risk concerned.

(2) Major Regulations

In 1978, China adopted its economic reform policy and gradually opened its doors to the outside world after this. Indirect trade/investment between China and Taiwan started to grow. During 1985 to 1990, five major developments in TDI regulations in China and Taiwan led to an increase in TDI flows into China in early 1990s. These developments (Yang, 1997; Wu, 2000; Hou, 2002) included: a) Taiwan's announcement of the "Noninterference Principle of Indirect Exports to the Mainland" in 1985; b) In 1987 Taiwan relaxed the financial restrictions for the remittance of foreign reserve and lifted martial law and began to allow visits to relatives in China; c) Since 1987, the Taiwanese government started to relax the limit on the outflow of capital to China, initially with a cap of $50 million per project, which was expanded to $100 million in early 2002, with larger projects approved on a 'case by case' basis (Skanderup, 2004); d) The Chinese government promulgated the "Regulations on Encouraging Taiwanese investments" in July 1988; and e) On October 6, 1990, the Taiwanese government announced "The Regulations on Indirect Investment and Technology Cooperation with the Mainland Area", and requested spontaneous registration and reporting of previous investment toward the Mainland.

Under pressure from Taiwan's business communities and industrial organizations, the Taiwanese government finally allowed TDI in China via a third country in 1990 (MOFERT, 1987-1997; Hou, 2002). The above mentioned developments in China and Taiwan led to a significant increase in the capital flow from Taiwan to China in the early 1990s (Yang, 1997), although the Taiwanese government still maintained restrictions on the amount and types of investment projects with which Taiwanese firms can engage in China (Siu et al., 2003). Wu (2002) suggests that the types of TDI projects in China are still classified into three categories among more than 9,000 items. These categories

include: a) A first category of investments which is strictly forbidden, and which accounts for 3.7% of the total types of TDI projects; b) A second category consisting of 34.4% of the total types of TDI projects which may need to be approved on a 'case-by-case' basis; and c) A third category consisting of 61.9% of the total TDI projects, which are allowed to invest in China. This third category includes the most labour-intensive industries (Wu, 2002).

Even under the allowed investment categories Taiwanese firms can directly invest in China only if their accumulated investment amount is less than one million US dollars within a two year time span. However, if the amount is over one million US dollars, firms have to be subsidiaries which are financially independent from their headquarters (Lin and Liang, 2003). Under this circumstance, the fact is that most Taiwanese firms again have choosen not to report their investments in China to the Taiwanese government (Wu, 2000; Hou, 2002; Lin and Liang, 2003) to avoid dealing with bureaucratic procedures.

3.2 The Characteristics of TDI in China

Taiwan has emerged in recent years as the second largest investor in China. Compared with its investments in other parts of the world, TDI in China has demonstrated some unique characteristics. Most studies (e.g. Chiu 1995; Yang, 1997; Chen, 1997; Lin and Liang, 2003) show that while the total investment volume is large, the average individual investment size is fairly small; the investments are widely disbursed across export-oriented and labour-intensive industries, yet they are geographically concentrated in a few coastal areas. Most studies (e.g. Lemoine, 2000; Hou, 2002) also point out that there is a statistical bias in measuring TDI inflow into China. This section reviews these unique characteristics of TDI in China including: indirect investment, rapid growth with moderate investment size, regional bias, statistical bias in the volume of TDI, and uneven sectoral distribution.

3.2.1 Indirect Investment

Indirect investment in China was not officially recognized until 1990, though such activity dated back to 1983 (Wu, 2000). Existing literature acknowledges (e.g. Breslin, 2003; Lin and Liang, 2003) that a large number of Taiwanese firms invest in China but channeled this through a third area, such as Hong Kong, the British Virgin Islands and the Cayman Islands, partly to take advantage of the tax regime, but also to bypass the Taiwanese government restrictions on investment in the Mainland. The statistical data shows that after China, the British Virgin Islands and the Cayman Islands rank second and third respectively as the biggest recipients of Taiwanese outward investment (Breslin, 2003).

Taiwanese companies had to make investment through foreign holding companies in a third country to avoid dealing with bureaucratic regulations with the Taiwanese government. A recent study by Lin and Liang (2003) shows that these third countries offered favourable treatment such as taxation exemption, a tax credit, applications for a lower tax rate, and other incentives. In addition, they protected business secrets, had a more relaxed foreign exchange control, and provided a healthy site for international offshore financial centres.

Lin and Liang's study (2003) explored how TDI is channelled through third countries. This study uses 855 companies as an example offered by the data based on the Taiwan Economic Journal. Major findings in this style include a) the first four investment centres included: Virgin Islands (166 firms, 34.5%), Hong Kong (114 firms, 23.7%), Singapore (72 firms, 15%) and the Caiman Islands (39 firms, 8.1%); b) the amount of foreign direct investment there accumulated to 10.8 billion dollars from 470 publicly-listed companies. Those companies come from industries of electronics (US$3.13 billions), food (US$1.66 billions) and textiles (US$985 millions); c), most of them had choosen FDI (45.32%) and major ownership (31.19%), but very few selected a strategic alliance (Lin and Liang, 2003). This study reveals that indirect investment still plays an important role in TDI into China.

3.2.2 Rapid Growth with Moderate Investment Size

The average size of TDI in China has been much smaller than that in ASEAN countries and the United States (Yang, 1997; Table 3.5, Table 3.6 and Table 3.7). For example, OECD (2000) found FIEs from Taiwan and Hong Kong have a lesser contribution to total fixed investment, and that their investment conveys much less expenditure for machinery and equipment than in developed countries. More recently, large Taiwanese companies have invested in China with larger investments and higher technologies. Compared with TDI in other parts of the world, the total TDI in China is large (Lin, 1995; Huang, 2000; McLenahan, 2002; Huang et al., 2004) although average investment is smaller than that from other developed countries in China.

The reasons behind this pattern of investment scale of TDI (Chiu, 1995; Yang, 1997; Xie, 2002; Zhang et al., 2003; Chen, 2003; Huang et al., 2004) include: a) the majority of TDI in China are conducted by small-and medium-sized firms or individuals with moderate capital commitments; b) cultural and linguistic proximity; and c) political uncertainty and restrictions in the size and types of individual investment projects because of the political uncertainty and restrictions in the size and types of individual investment projects.

The fact is that the Taiwanese economy is still dominated by small and medium sized family firms characterized by heavy dependence on contracting relations, many of whom invested in China to seek lower production costs, and also by large firms who later invested more in China because of market expansion strategies. As most TDI in China is dominated by SMEs, this helps to explain why the average investment scale is smaller, and contributed less, to fixed investment in China.

Yang (1997) also argues that the ethnic and cultural bonds between Taiwan and China are another major reason for Taiwan's collectively large individually small investments in China. The cultural difference may discourage many SMEs from going abroad. However, the cultural and linguistic proximity between China and Taiwan can help Taiwanese

investors find appropriate low-profile investment opportunities in local industrial in China.

On the other hand, as mentioned in previous sections, political considerations and Taiwan's Mainland investment regulations have again played an important role in the investment scale of TDI into China (Chiu, 1995; Xie, 2002; Zhang et al., 2003; Chen, 2003; Huang et al., 2004).

3.2.3 Regional Bias

Apart from the moderate investment size, TDI in China is also characterized by a very uneven geographic distribution (Yang, 1997; Chen, 1997; Hou, 2002; Lin and Liang, 2003; Table 3.8). Chen's study (1997) shows that the top three host provinces for Taiwanese investors were Fujian, Guangdong, and Jiangsu, from the period of 1987 to 1991. The share of the top three host provinces in the total investments of Taiwanese investors was 67 per cent. Chen (1997) suggests that it is clear that in this period the investments of TDI not only had a strong regional bias but also had a very high degree of regional concentration.

Since the early 1990s, Taiwan's investment has achieved a rapid growth. Originally, TDI were concentrated in the Fujian province due to the geographical, cultural and linguistic proximity between Taiwan and Fujian. Guangdong is another place that attracted many investment projects from Taiwan as an export base (Siu et al., 2003).

A recent research from Lin and Liang (2003) found a pattern of change in TDI location in China. Most Taiwanese firms located their facilities near the coasts. Some of them placed overseas branches in special economic and technology zones, and the rest in the tax-bound areas. 46 per cent of Taiwanese companies, focusing on seeking cheap production factors, established their subsidiaries in the Guangdong province in 1992 to take advantage of the financing and transshipment in Hong Kong and the bountiful human resources in China. Guangdong alone has received 30 per cent of TDI over the 1991 to

July 1995 period. In the same period of time, Guangdong, Jiangsu, Shanghai, and Fujian together accounted for 73.29 per cent of the total TDI in China (Yang, 1997).

When the TDI motive was changed from resource-seeking FDI to market-seeking FDI, 51% of the firms situated branches in the Suzhou Industrial Park in 2001 which provided highly qualified talents, a healthy infrastructure and advanced technologies. Kunshan city, in particular, has turned out to be the most popular site in attracting TDI (Lin and Liang, 2003).

Hou's (2002) research shows that the changes in regional pattern of TDI over time suggest that in the 1990s TDI exhibited a trend toward a rising market-orientation, as more TDI took place in large cities (Shanghai, Beijing, and Tianjin) rather than export-promotion-based provinces (Guangdong and Fujian). Gupta (2003) also notes that TDI has spread beyond the eastern coasts of the Fujian and Guangdong provinces. Statistics (Table 3.8) show that the most popular destinations for this investment were, in descending order, Guangdong, Jiangsu, Shanghai, and Fujian in 2003.

The geographical concentration in coastal areas associated also with uneven economic development (Yang, 1997; Wei, 2003) in China due to China's selective FDI policy (Wei, 2003) has included preferential treatment (tariff exemption and fiscal reductions) in areas in which FDI has been encouraged (Lemoine, 2000), and with proximity to Hong Kong (Yang, 1997).

Table 3.8 Taiwan Approved Investment in Mainland China by Area, 1991-2003 (number of cases)

Area/Period	1991-1994	1995	1996	1997	1997*	1998	1998*	1999	2000	2001	2002	2003
Guangdong	3,526	114	93	283	3,136	274	274	177	288	315	877	1,228
Fujian	1,742	52	66	71	955	59	78	44	32	37	536	522
Guangxi	96	0	1	3	59	2	6	3	2	0	15	19
Hainan	163	1	0	7	126	1	11	4	2	2	5	11

Shanghai	1,224	89	65	105	835	113	65	70	163	297	568	641
Jiangsu	1,137	74	64	103	748	83	63	99	225	314	639	815
Zhejiang	560	27	21	35	412	25	21	27	36	72	171	215
Hubei	120	7	4	6	241	1	20	7	1	14	12	31
Hunan	118	29	3	10	80	2	6	1	1	4	11	11
Chongqing	52	2	1	7	53	1	5	4	1	3	10	14
Sichuan	127	1	4	5	84	9	8	1	4	7	25	19
Beijing	350	23	9	21	191	18	20	22	44	59	78	100
Tianjin	231	16	13	15	397	13	7	8	5	18	38	37
Hebei	151	9	4	8	52	7	4	4	4	3	8	12
Henan	138	4	1	2	40	1	6	1	2	2	10	8
Shandong	348	8	10	16	234	11	18	4	8	11	40	80
Liaoning	213	10	8	9	138	4	7	5	10	9	28	42
Jilin	37	0	0	2	19	1	2	0	1	2	2	1
Heilongjiang	14	5	0	2	9	2	1	0	0	1	0	2
Others	386	19	17	17	170	14	20	5	11	16	42	62

Note:

1. Figures * mean lagged reports and approvals

2.The figures are not added up to the total due to rounding up.

Source: Investment Commission, MOEA, Taiwan, 2003.

3.2.4 Statistical Bias in the Volume of TDI

Statistical bias in the volume of TDI reflects two issues: 1) Chinese and Taiwanese official sources of statistics on TDI differ substantially; 2) Both official sources of statistics underestimate the actual amount of TDI in China (Hou, 2002).

It should be noted that two sources of statistics on TDI, the official data from China and that of Taiwan, differ substantially (Hou, 2002). A recent study by Yang and Tu (2004) also acknowledges there is a statistical bias in the volume of TDI. The authors (2004) found that the official statistics on Taiwanese overseas investment, as provided by the Taiwanese government, differ significantly from those provided by the countries in which the investments take place. Their empirical results show that the proportion of unregistered investment tends to be higher in South-East Asia and China than in the USA, and that complicated administrative procedures have a positive influence on this type of behaviour. The main reason for the difference is that the Taiwanese government restrains TDI in China. Therefore, many Taiwanese investors choose not to report their cases to the Taiwanese government. Hou (2002) suggests that the gap is huge and that the number of cases, and realized investment amounts from the official data of China in 1991 to 1998 almost doubled compared to that based on Taiwanese statistics.

According to official Chinese statistics up to the end of 2003, the accumulated total of TDI in China was 58,544 cases, with a contracted amount of US$687,135 million, or 7.61% of the total FDI in China (See Table 3.9). These figures far exceed those published by the MOEA, which shows the approved accumulated total of TDI in China is only US$343,085 million (See Table 3.10). Again, the gap is huge between the number of contracted investments from the official data of China in 1991 to 2003 and the approved TDI based on Taiwanese statistics.

Table 3.9 Statistics on TDI into China, 1991-2003 (unit: US$10,000)

Year	Number of Items	Contracted Amounts	National Total
1991	1,735	138,852	1,197,682
1992	6,430	554,335	5,812,351
1993	10,948	996,487	11,143,566
1994	6,247	539,488	8,267,977
1995	4,847	584,907	9,128,153
1996	3,184	514,098	7,327,642
1997	3,014	281,499	5,100,353

1998	2,970	298,768	5,210,205
1999	2,499	337,444	4,122,302
2000	3,108	404,189	6,237,952
2001	4,214	691,419	6,919,455
2002	4,853	674,084	8,276,833
2003	4,495	855,787	11,506,969
1991-2003	58,544	6,871,357	90,251,440

Source: Foreign Investment Administration of MOFCOM, China.

http://fdi.gov.cn/common/info.jsp?id=ABC00000000000016781

Table 3.10 Statistics on Approved TDI into China, 1991-2003 (unit: USD10,000)

Year	Amount
1991-1992	42,115
1993*	316,841
1994	96,220
1995	10,9271
1996	122,924
1997*	433,431
1998*	203,462
1999	125,278
2000	260,714
2001	278,414
2002*	672,305
2003*	769,878
Total	343,0856

Note: Figures * includes lagged approval.

Source: Investment Commission, MOEA, Taiwan, 2005.

Apart from the fact that Chinese and Taiwanese official sources of statistics on TDI differ substantially, a few scholars (e.g. Lemoine; 2000; Hou, 2002; Wang, 2004; Yang and Tu,

2004) also acknowledge that the official statistics are an underestimation of the volume of TDI in China.

Three reasons explain the statistical bias in the volume of TDI in China (Lemoine, 2000; Wang, 2004): 1) Many Taiwanese firms invest in China via a third area (SSB, 1999; Lemoine, 2000). Lemoine (2000) suggests that in Chinese statistics, FDI is registered as coming from the place where the investing firm is incorporated, but may not reflect the actual home country of the invested funds. Therefore, the actual TDI in China can be much larger than the official statistical data; 2) Certain investments in China may be unknown to the MOEA because they were following unconventional channels or investing in categories, or in ways, not complaint with current laws (Wang, 2004); and 3) Calculation by different official sources use different data. For example, the MOEA base their statistics on actual investment, whereas the MOFCOM use contracted amounts; in addition, the MOEA counted compensation for processing and assembly work as trade rather than investment (Wang, 2004).

In general it is thought that the Chinese data stand closer to the truth, but many Taiwanese investors were still investing in China via a third country, again contributing to an underestimation of the amount of TDI in the data from Chinese official sources (Wang, 2004).

3.2.5 Uneven Sectoral Distribution

TDI in China is characterized by a very uneven sectoral distribution (Siu et al., 2003; Huang et al., 2004). Previously TDI were dominated by export-oriented labour-intensive manufacturing industry undertaken by the SMEs. Also, compared with other major source countries, such as Japan, TDI in China seems to be more labour-intensive than Japan's FDI in China (Siu et al., 2003).

In the past two decades, the sectoral distribution of TDI has witnessed important changes. In the early period, the investment from Taiwan was similarly dominated by export

oriented and labour-intensive manufacturing industries, such as the "city of shoes" established by the Taiwanese investors in Dongguan (Lai, 2002). Most TDI in China has been labour-intensive industries including garment, textiles, footwear, plastic household products, electronics, and electrical appliances, which are also Taiwan's major exports (Huang et al., 2004).

Recently TDI have been towards market-oriented industries instead of export-oriented industries, especially for SMEs. Chen (1998) argues that the most interesting aspect is the strong orientation that Taiwanese firms, especially SMEs, have towards selling in the domestic markets of the host countries. In the past Taiwanese SMEs have always been highly export-oriented. Confronted with rising domestic wages, taking the path of TDI has been with the objective of gaining access to low-wage labour. However, after investing in China, these Taiwanese firms have shown a strong desire to sell in the local market rather than export to other countries. Chen (1998) interpreted the reason behind this change as being 'frailness of technologies advantages' for Taiwanese SMEs in China.

Apart from the characteristics of Taiwanese SMEs, the investment projects from Taiwan began to exhibit different characteristics from the traditional ones. The Taiwanese firms with larger capital started to engage in large-scale projects. Especially from the mid-1990s, TDI flowed into more technology-intensive sectors such as the IT section (Lai, 2002; Siu et al., 2003). For example, It has been reported that a significant amount of IT products have been produced by Taiwanese firms in China. Taiwanese firms also expanded their investment scope to real estate, insurance, banking and tourism (Siu et al., 2003). The reason behind the change in the sectoral distribution of TDI is the Taiwanese government's constraints on investment to China (Lai, 2002) and China's WTO entry (Gupta, 2003). As the Taiwanese government gradually relaxes the constraints on investment to China, there appears to be a new wave of investment for technology-intensive industries from Taiwan. Therefore, recent TDI has been conducted by the petrochemical and steel industries, and eventually high technology industries such as consumer electronics and computers (Huang et al., 2004).

Lin and Liang (2003) also find that the focus of management had changed from labour-intensive export-oriented industries in the early stages to market-oriented industries during 1990 to 1996. The sectoral distribution of the market-oriented TDI was mainly in consumer goods, restaurant, entertainment and raw materials. After 1997, power and electronics companies, technology and capital intensive, were two major types of investors. This change in sectoral distribution also resulted from FDI policy incentives from the Chinese government, such as favorable tax treatments, the low cost of land usage and reduced export ratios during the period of 1995 to 2000 (Lin and Liang, 2003).

China's WTO entry is another reason for the change in the sectoral pattern (Gupta, 2003). For example, Gupta (2003) suggests that Taiwan businessmen are also investing in activities other than export manufacturing, having established Mainland offices to handle real estate, insurance, banking, and tourism. As the Chinese market gradually opens under the WTO agreement, this has increased Taiwan's large enterprises in the information, plastics, and food and beverage industries, which have set up large-scale projects in China to take advantage of the huge domestic market.

In summary, in the early stages of FDI from Taiwan to China, traditional industries were the first movers into China, but the patterns have been gradually changing to technology-intensive industries. The reason behind the changing patterns is the Taiwanese government's Mainland investment policy, and China's WTO entry.

Table 3.11 Approved TDI in China by sectoral, 1994-2003 (unit: US$1million)

Year	Total TDI in China	Sectoral					
		Food and Beverage Processing	Plastic Products	Basic Metals & Metal Products	Electronic and Electric Appliances	Precision Instruments	Others
1994	962,209	145,846	73,302	90,328	157,011	44,162	451,560
1995	1,092,713	117,447	62,736	116,805	214,796	29,454	551,475
1996	1,229,241	121,702	63,645	128,123	276,862	39,898	599,011
1997	4,334,313	333,073	349,116	395,967	875,044	247,249	2,133,864
1998	2,034,621	70,045	64,184	126,849	758,975	74,617	939,951
1999	1,252,780	58,250	99,074	104,494	537,751	28,073	425,138
2000	2,607,142	43,253	184,776	183,854	1,464,775	84,797	645,687

2001	2,784,147	58,420	156,067	193,797	1,254,834	125,997	995,032
2002	6,723,058	152,939	398,820	631,461	2,618,684	433,348	2,487,806
2003	7,698,784	353,050	412,804	714,530	2,330,030	478,222	3,410,148

Note: Figures included lagged reports from July 2002 to July 2003 and approvals

Source: Investment Commission, MOEA, Taiwan, 2004

In summary, TDI in China can be characterized by rapid growth but also large volume in aggregate, with small individual size, and a regional bias as well as a statistical bias in measuring TDI in China, which changed from exported-oriented to market oriented industries.

Due to these and other different characteristics, it is interesting and important to take a deeper look at the motives, entry modes and choice of locational determinants of TDI in China, which will be explored in the next few sections.

3.3 Motives for TDI

According to Dunning (1977, 1981), an MNE will choose FDI over export and licensing if there are ownership, location, or internalisation advantages. As Taiwan and China have been under political tensions for more than four decades, the motives for TDI flows into China have raised a number of important new challenges while, to some extent, creating new constraints for policy makers in Taiwan. Therefore, this section aims to answer two questions. 1) Why Taiwanese firms are forced to shift from exports to international production in the first place? And, 2) what motivates these investments from Taiwan into China?

In aiming to explore the motives for TDI in China, the following theories can help provide explanations: Dunning's OLI paradigm, the economic proximity, the 'center-satellite network' (*zhongwei tixi*; subcontracting system), and push and pull forces.

The 'center-satellite network' is an important motive for TDI in China and also an important determinant in TDI's locational choices in China, which will be explored in chapter 4 as more complicated issues are involved in this subject. This section will explore the other three theories.

3.3.1 OLI Theory

It has been argued that Dunning's (1979) OLI paradigm: ownership advantages (O), locational advantages (L), and interalisation advantages (I) is useful in characterizing TDI inflows in China. The OLI paradigm suggests that a firm is likely to engage in FDI when it possesses resources that can be effectively employed within a particular host country. Although support for this theory is generally found in developed countries, its application in emerging economies remains unclear (Plummer and Montes, 1995; Huang et al., 2004).

As Plummer and Montes (1995) suggest, while the OLI paradigm is extremely useful in characterizing FDI dominated by large MNEs and occurring between the United States and Europe, the economic theories of FDI may not be readily applicable to the unique patterns associated with TDI in China. For example, Yang (1997) argues that Taiwanese firms investing in China do not have ownership advantages. Zhang (2002) also argues that the significant share of the FDI from Asian developing economies raises the question about their competitive edge in the world market for investment, because Hong Kong and Asian developing country firms appear to lack ownership advantages such as advanced proprietary technology and established brand names.

A few scholars (Luo,1997, Tsang, 1998; Zhang, 2001; Hou and Zhang, 2001; Hou, 2002), however, argue that FDI from Taiwan does have ownership advantages. The ownership advantages of TDI might be derived from either marketing skills that make investors specialize in delivering timely, internationally marketed, uniform quality products to Western markets or adaptations of mature technologies to more labour intensive contexts and from local raw materials (Hou and Zhang, 2001; Hou 2002). Hou and Zhang (2001) assert another unique ownership advantage as being Taiwan's ethnic connections with

China. Other studies (e.g. Luo,1997, Tsang, 1998; Zhang, 2001) suggest that Taiwanese firms have unique ownership advantages because of *guanxi*-ties, allowing ethnic Chinese investors to negotiate and operate their joint ventures advantageously relative to other foreign investors. An ethnic connection is the so called shorter "cultural differences" (Baraga and Bannister, 1994) between host country and foreign investor, which will be explored in the next section.

Hou (2002) suggests that there has been a strong locational advantage in terms of the existence of underutilized quotas under the Multi-fiber Arrangements, which has proved an important incentive to firms from countries whose quotas are fully used up. Hou (2002) suggests that China has been threatened by the US to be put under the Super 301 Watch List, which can be reviewed as indirect evidence of the extent of such FDIs. Therefore, it is an important incentive for TDI in the garments industry. Hou (2002), therefore, asserts that TDI investment in China is in line with Dunning's OLI paradigm.

In summary, Taiwanese firms may not be on the world frontiers of technology and organizational sophistication, but they do have ownership advantages and locational advantages (Hou an Zhang, 2001; Hou 2002).

3.3.2 Economic Proximity

The factors affecting economic proximity include the geographic distance, cultural differences, and regulatory barriers (Chen, 1997; Baraga and Bannister, 1994). The higher economic proximity, the lower the costs arising from the geographic distance, cultural differences and regulatory barriers (Baraga and Bannister, 1994).

TDI can be considered as specific since it benefited from FDI policy incentives from the Chinese government and it was enhanced by strong cultural and family links with China (Lemoine, 2000). In China, Taiwanese firms are in a much better position to manage the investment risks compared with American and European firms. Taiwanese firms can control their Chinese subsidiaries from Taiwan, because the region is part of the same

time zone (Ernst, 1997) and China and Taiwan share the same language and a similar culture.

The Taiwanese originally came from the coastal areas (Fujian in particular). The Taiwanese can be categorized into four *shengji* groups: *benshengren, waishengren, kejiaren*, and *yuanzhuming*. *Benshengren,* who originally come from the Fujian province, and *kejiaren* who originally come from the Guangdong province. The enthusiasm of TDI in Fujian can be explained as a shorter cultural difference in terms of the shorter differences in culture and language between Taiwan and China. The Taiwanese investors' ethnic networks and cultural links serve as a key advantage when compared to investors in Japan and the West (Chang, 2002). Rauch & Trindale (1999) also suggest that Taiwanese cultural and linguistic affinities with China help them find appropriate low-profile investment opportunities in local industries in China. Therefore, the motivation for TDI is partially due to economic proximity. To some extent, China has become a favorite relocation destination for Taiwanese investors, not only due to low labour cost attraction, but also because of its ethnic, cultural and linguistic affinities.

3.3.3 Push and Pull Forces

The broad background of TDI in China may be summarized into the "pull" force of China which made China more attractive to Taiwanese investors, and a "push" force from Taiwan which stimulated growing capital outflows (Hou, 2002). A few studies (Lin, 1995; Fuess and Hou, 2001; Chen, 1999; Hou, 2002; Lin and Liang, 2003) explore the push and full force in explaining the motives for TDI into China. The next two sections aim to explore the motives for TDI under the push and pull forces.

(1) Push Force

Four macroeconomic factors (Lin, 1995; Lin and Chen, 1998; Chen, 1999; Fuess and Hou, 2001; Hou, 2002; Lin and Liang, 2003; Wang, 2004) are identified as push forces which are important to the TDI boom: wages rises, labour shortages, the currency appreciation, difficulty in land acquisition, and industrial structure upgrades.

The major push forces are wages, which rose substantially at the same time as there were labour shortages during the 1980s (Wu and Chang; 1991; Chaponniere, 1992; Kumar, 1995; Addis Ababa, 2001; Hou, 2002). Most of the SMEs are now ending up in Mainland China. Taiwan had an ample supply of well-educated and skilled workers. However, labour shortages still exit in some industries, including semiconductor and computer chip design and production, computer software design, securities brokerage, futures trading, and foreign-exchange services. The supply of unskilled workers remains relatively tight among consumer electronics, pottery, metal pressing, and public construction works (Gupta, 2003).

Taiwan entered a stage of labour shortage in the 1980s and had to face the choices of engaging in FDI or receiving foreign workers. Between 1990 and 1992 alone, industrial wages had moved by nearly 35 per cent (Chaponniere, 1992; Kumar, 1995). In the late 1980s and early 1990s, there were massive outwards FDI from Japan, Taiwan and other NIEs to Southeast Asia due to labour shortages (Wu and Chang, 1991).

The foreign exchange rate policy is considered to be one of the major push forces that motivated the TDI volume. Since 1987 the Taiwanese government had become increasingly liberalized toward FDI outflows as it lifted its foreign exchange control (Tung, 2000). Similar to what happened with Japan's Yen's appreciation in 1985 (Ernst, 1997), Taiwan's currency appreciated sharply in the late 1980s, and Taiwanese firms were under tremendous pressure and did not have time to proceed gradually. Under the impact of Taiwan's currency appreciation, Taiwanese manufacturers in exported-oriented and labour intensives industries were quickly loosing their market share in the US and Europe. Similar to Japan's FDI experience in the 1980s (Ernst, 1997), the solution to sustain the Taiwanese market share in the US and Europe was to relocate export plants to lower-cost production sites in Southeast Asia. Therefore, Lin (1999) suggests that the abolition of foreign exchange controls and the sharp appreciation of the Taiwan currency indeed play a significant role in motivation for the TDI in the 1980s. These two factors permitted actual capital outflows and motivated the Taiwanese firms to invest in low-cost regions.

Difficulties in land acquisition (Hou, 2002) gave rise to concerns about de-industrialization in Taiwan and motivated outwards TDI. De-Rowthorn and Coutts (2004) define de-industrialization as a secular decline in the share of manufacturing in national employment. De-industralization, in this sense, has been a universal feature of economic growth in advanced economies in recent decades. In the case of Taiwan, the employment share of manufacturing had been rapidly failing. Taiwan was also facing the same problems and uncertainties that have been confronting Europe and the United States for decades (Rowthorn and Coutts, 2004) in terms of de-industrialization.

The Taiwanese government aims to upgrade its industrial structure from labour intensive to capital and technology intensive industry (Hou, 2002; Lin and Liang, 2003; Ng, Tuan & Yu, 2004; Huang, 2004; Wang, 2004) because of increasing international competition. Adjustments made to the industrial structure and export structure are expected to sustain Taiwan's comparative advantage. In the late 1980s, Taiwanese industrial structure started to change from labour-intensive industries to capital and technology-based industries. At the same time, the structure of Taiwan's trade was changing from low-end to high-end consumption goods, which reflecting the ongoing upgrading of Taiwan's export structure. A recent research by Ng et al., (2004) also suggests the recent accession of Taiwan into the WTO in 2001 renders further the topic of restructuring its economy a more urgent issue than ever before.

In summary, the TDI motives for the push are formed from the abolishment of foreign exchange controls and sharp appreciation of the Taiwan currency, the rising labour cost, difficulty in land acquisition and the adjustments in its industrial structure.

(2) Pull Force

As for the TDI motive under the pull forces, a few important pull forces offered by China are identified: lower cost in skillful labour, a huge market size, cheap-abundant resources, fellow customers or competitors, and FDI incentives from the Chinese government.

A recent study from Lin and Liang (2003) investigated 699 electrical and electronic companies as a sampling frame that had invested in China. The most cited motives are to exploit cheaper labour, following customers or competitors, and capturing first-mover advantages and the potentiality of local demand (see Table 3.12 Strategic Motives for Taiwanese Direct Investment in China).

A similar study by Hou (2002) suggests that the usual attractiveness of China includes its huge market size, the low labour costs, and cheap-abundant resources, such as raw materials and land, which are all obvious pull forces. The pull force is the evolution process of China's attitude towards FDI as reflected in the Chinese government's economic policies.

The SMEA White Paper (2004) also suggests that the motivation for a Taiwanese company investing in China were: the desire to reduce labour costs, comply with customers' requirements, increase production capacity, achieve competitive advantage on cost, develop new markets, spread risk, gain access to new sources of production resources, expand into other industries, etc, which are mostly motivated by resource-seeking, efficiency-seeking and market-seeking FDI. Chen and Ku (2002) assert that resource-seeking TDI strategy is the most effective among large firms in mature industries. Large Taiwanese firms take advantage of the scale of the economy in China, and relocate production networks and pursue vertical integration. Therefore, large firms gain shares in world markets, which in turn, enable them to diversify product lines or engage in risky R&D (Chen and Ku, 2002).

Table 3.12 Strategic Motives for Taiwanese Direct Investment in China

Item	Average (standard deviation)
1. Cheap land and labour cost	5.778(0.921)
2. Major customers went to China	5.667 (0.947)
3.Competitor went to China	5.757 (0.929)
4.Capture advantage	5.602 (0.986)
5.Great local demand	5.463 (0.932)

6.Tax exemption	5.462 (1.018)
7.Low raw material cost	5.426 (1.104)
8.suppliers went to China	5.343 (1.025)
9.Customer's demand is globalized	5.296 (0.950)
10.Local customers prefer international brand	5.278 (0.905)
11. Well-constructed in industrial park	5.112 (0.960)
12. Local sourcing	5.111 (1.1187)
13. Shortened product life cycle	5.102 (1.041)
14. Shorter culture distance	5.093 (0.914)
15. Easy to register in China	4.935 (1.044)
16. Lower exchange rate risk	4.639 (1.045)

Source: Lin and Liang, 2003.

In summary, this section has explored the motives for TDI in China, which can be explained by the following theories: the OLI paradigm, economic proximity, the 'center-satellite network' (*zhongwei tixi*; subcontracting system), and push and pull forces. The 'center-satellite network' is an important motive for TDI in China and also an important determinant in TDI's locational choices in China, which will be explored in chapter 4.

China has become a favorite relocation destination for Taiwanese investors, not only because of cost considerations, but also because of Taiwan's economy structural upgrading, the 'center-satellite network' the industrial structure attraction, geographical, cultural, and language proximity.

3.4 Determinants of TDI

While China-related FDI issues have increasingly drawn the attention of researchers over the years (e.g. Cheng and Kwan, 2000a, 2000b; Tseng and Zebregs, 2002; Chen and Chen, 2002; Shi et al., 2002; Wei, 2003; He, 2003a, 2003b; Wei and Liu, 2004; Zhang et al 2004), a systematic analysis of the determinants of TDI in China has been relatively

limited. This section reviews and explores the literature regarding the determinants of TDI.

The existing studies categorize the major determinants of TDI in China into two groups: studies at national level (e.g. Chen, 1991; Chen, 1992; Lin, 1995; Hsieh, 1997; Chen and Ku, 2002; Li and Hu, 2002) and those at regional level (e.g. Yang, 1997; Cheng and Kwan, 2000a, 2000b; Hou and Zhang, 2001; Fung et al., 2005). The major determinants found in this literature review are aspects such as firm size, cost factors, the market size, successful export experience, labour quality, the political environment and cultural differences, as well as agglomeration and the FDI policy which have a positive influence on TDI in China.

(1) Market Size

Most studies (e.g. Hou and Zhang, 2001; Tien, 2002; Wang, 2004) agree that market size should be considered as one of the most important determinants of TDI in China at either national or regional levels. As China's domestic market gradually expanded, the desire to get a market share in the domestic market became an important motivation for Taiwanese companies investing in China. Since China's WTO entry, there has been a new wave of investment in China with an increase in both the scale of investment and the level of production.

Tien (2002) suggests that the changes in determinants of TDI in China over the last few years have two main features: 1) Initially, TDI in China was in response to changes in the economic environment in Taiwan. The main emphasis in the first place was on exploiting China's cheap labour; 2) In the last few years, following China's rapid economic development, TDI has been concentrated in the domestic market. Market size, therefore, is considered to be one of the most important determinants of TDI in China.

(2) Cost Factors

Taiwan has been adversely affected by currency appreciation and rising domestic wages. Taiwanese firms have responded by moving production abroad to maintain their international competitiveness (Kumar, 1995). Empirical research by Li and Hu (2002) shows that the wage rate is a significant determinant for SMEs from Taiwan who engage in FDI at national level, while the setup cost is not seen as an important factor. SMEA (2004) suggests that the determinants of TDI at national level was normally based on the availability of low-cost production factors in terms of low wages, cheap land for factory construction, and the FDI incentives by the host country. However, Hou and Zhang (2001) find that labour costs plays no significant role after 1991 on the determinants of TDI at regional level.

(3) Labour Quality

The evidence in Gao's (2004) paper indicates that the location of FDI from developed economies such as the United States and Japan is more sensitive to labour quality than FDI from the developing economies of Asia. Hou and Zhang (2001) found labour quality plays no role in TDI locational choices in China during 1987 to 1990. However, labour quality is a significant determinant during 1991 to 1994 and 1995 to 1998. It shows that there has been a structural change over time for determinants of locational change of TDI in China. Another recent study by Siu et al. (2003) found labour quality is a significant determinant in TDI locational choices in China during 1990 to 2002.

(4) Successful Export Experience

Research shows that the tendency to export is positive relative to the tendency to engage in outwards TDI (Chen, 1991; Chen, 1992; Lin, 1995). A few studies (e.g. Chen, 1991; Chen, 1992 and Lin, 1995) agree that the common factors that drive both large and small Taiwanese firms to venture abroad is a successful export experience prior to FDI.

A recent empirical study from Huang et al. (2004) found evidence that is not fully consistent with some of the other empirical studies, even though the majority of previous

literature suggests that firms engaged in FDI must possess firm-specific advantages to outperform the local competitors in the host markets. Huang et al. (2004) confirm that a firm's international experience is positively related to the extent of TDI and the firm's performance in China. Empirical results from this study show a Taiwanese manufacturing firm with a certain level of experience in overseas markets tends to invest more in China than one without the same level of experience. Therefore, previous international experience is a significant determinant of TDI in China (Huang et al., 2004).

(5) Firm Size

Most recent research agrees (Chen, 1992; Chen and Ku, 2002) that existing firm size measured by total assets, total sales and number of employees is an important determinant in TDI.

Chen's (1992) research shows that TDI is motivated by different factors under different macroeconomic conditions. The microeconomic determinants of TDI vary with firm size, although on average, large firms are more inclined to make TDI than small firms. The securing of raw material supplies seems to be a major concern of large firms but has little importance in the TDI decisions of small firms. Small firms with good growth potential are strongly inclined to engage in TDI, probably to overcome the resource and market constraints inherent in the source country (Chen, 1992)[16].

Large firms, as previous studies suggest, tend to possess higher R&D capabilities, which may allow firms to achieve higher efficiency and better performance (Khan et al., 2004). However, Huang et al. (2004) found that firm size does not seem to be an important predictor of Taiwanese firms' performance in China as most TDI into China is carried by SMEs from Taiwan. Yang (1997) suggests that most TDI into China are carried by SMEs because of the similar cultural backgrounds and language. Therefore, this implies that firm size itself impacts on the TDI's location choice at national level as smaller firms

[16] I very much appreciate Dr. Chen sending several copies of his studies regarding TDI to me. They are important items of literature on TDI.

have little capacity to conduct outward TDI. However, similar language and cultural backgrounds may reduce the set-up cost in conducting outward TDI for smaller firms.

(6) Political Environment

The emphasis of the TDI decision on political risk considerations in China is due to the yet-unsolved cross-Strait political tension between China and Taiwan.

Hsieh (1997) suggests that in the decision of the Taiwanese to make investment, and in China in particular, the political environment is the primary consideration at national level. Hsieh suggests that the determinants of TDI in China at the local government level are the legal environment, constraints on development period, and the FDI incentives from local government. However, a dissenting view from Hsiao and Hsiao (2004) suggests that political risk plays a lesser role in the determination of TDI in China.

(7) Culture Difference

Most studies agree that shorter cultural differences will encourage FDI inflows into China (e.g. Yang, 1997; Wei and Liu, 2001; Zhang, 2001; Zhang, 2002; Tseng and Zebregs, 2002; Zhang et al., 2004). Linguistic ties also have a positive influence on the FDI inflow into China (Yang, 1997; Zhang, 2002; Wei, 2000; Tseng and Zebregs, 2002).

Exiting literature (e.g. Yang, 1997; Chen and Chen, 1998; Hou, 2002; Chang, 2002; Huang et al., 2004; Hsiao and Hsiao, 2004) agrees that the Taiwanese investors' ethnic networks and cultural bonds with China serve as a key determinant of, and motivation for, TDI in China. Mainland Chinese and Taiwanese share a common culture, values, and language, as well as strong family and village ties (Rauch, 1999; Lau et al., 2002; Huang et al., 2004). SMEA (2005, p115) commented on linguistic and cultural ties:

"there was a tendency to invest in countries where the ethnic Chinese business network was strong, especially Southeast Asia and China, which felt closer to home for Taiwanese enterprises".

Yang (1997) identifies three major determinants of TDI locational choice in China: FDI policy, geographical proximity, and ethnical networks and cultural bonds. Yang (1997) suggests that locational choices may be an indication of an information cost advantage that Taiwanese investors enjoy in these areas. Taiwanese investors are not only geographically close to the coastal areas in China, they also share the local culture and local dialects. Cheng and Kwan (2000a, 2000b) also assert that the most important source economies investing in China (i.e., Hong Kong and Taiwan) are close to some provinces but not to others. In contrast, Western Europe and Japan, the most important sources of FDI for the US, are not particular close to any of the American states (Cheng and Kwan, 2000a, 2000b). Empirical results from Cheng and Kwan (2002a, 2002b) also confirm that cultural difference plays an important role in the determinants of FDI at regional level.

(8) Agglomeration

Among the factors that generate location advantages for MNEs to invest, agglomeration is one of the crucial determinants, especially for East Asia. Although the micro-foundation of spatial agglomeration has not been fully analyzed, the importance of agglomeration as a source of location advantage is increasingly recognized in both empirical and theoretical literature (Ando and Kimura, 2003).

A few studies suggest that agglomeration (e.g. Hou and Zhang, 2001; Yeung, 2001: Jiang, 2003; Hsiao and Hsiao, 2004) is one of the most important determinants in locational choices of TDI into China. Jiang (2003) finds that once a specific industry has been established in an area, then others will follow to take advantage of the existing support for that industry. What is particularly notable in the Chinese case is that such clustering is built not only on the type of industry, but also the nationality of the investor, such as Taiwanese computer firms in Dongguan and IT firms in Suzhou. (Jiang, 2003; Breslin, 2003). Empirical results from Hou and Zhang (2001) also show agglomeration as a significant factor on TDI at regional level.

(9) Physical and Soft Infrastructure

Existing studies (e.g. Hou and Zhang, 2001; Fung et al., 2005) agree that the physical infrastructure plays an important role in attracting TDI flows into China at regional level. Most studies (e.g. Hou and Zhang, 2001; Fung et al., 2005) also agree that either China's or Taiwan's FDI policy (or so called soft infrastructure) plays an important role in locational choices of TDI in China.

Taiwan's FDI policy plays a significant role in locational choices of TDI in China. Yang (1997) suggests that TDI was clustered around Guangdong and Fujian till the early part of 1991 (which accounted for more than 70 per cent of the total TDI in China at the time). This was due to Taiwan's geographical proximity and easy accessibility to Hong Kong, the main vehicle through which this "indirect" trade and investment between Taiwan and China has been carried out under the Taiwanese government FDI policy towards China. Moreover, many Taiwanese who have Mainland-based ventures have choosen not to report their activities to the Taiwanese government because Taipei has banned the "three links" in terms of the direct communications by transportation, trade and post with China since 1949, when General Chiang Kai-Shek fled to Taiwan after losing a civil war to Mao Zedong's communist forces.

China's FDI policy also plays an important role in TDI locational choices in China. The economic reform in coastal areas is more advanced than the rest of China. Economic development and FDI incentives in these areas provide a favorable investment environment for Taiwanese investors (Yang, 1997). Empirical results from Hou and Zhang (2001) also find FDI incentives from the Chinese government play a significant role in locaitonal choices of TDI in China.

Hou and Zhang (2001) assess the factors that determine the establishment of Taiwanese new manufacturing-branch-plants in China and investigate their site-selection at the provincial level for three sub-periods (1987-90, 1991-94, and 1995-98). The results are in line with economic theory, however, as there were distinct shifts in the relative

importance of the determinants over time. This is indicative of the evolution of China's FDI policy, and the change in the nature of the Taiwanese firms involved in the TDI. This paper's significant finding is: A) in the early period, the main factors were FDI incentives (that the province offered) and the cultural link with Taiwan. B) In the second period, the aforementioned factors remain important but transportation costs became a significant concern. C) After 1992, when foreign firms were allowed to sell to domestic China, the importance of FDI incentives diminished, and cultural links became even less important. As expected, transportation increased in significance, while both the market size and the degree of industrialization of the province become important factors for the first time. Hou and Zhang (2001) assert two interesting findings. First, there is strong evidence of structural change over time. Any study that fails to address this will run the risk of giving misleading results. Second, contrary to common belief, the R&D expenditures of the province play no role in the location decision of TDI, regardless of the Chinese policy.

In summary, China has become a favorite relocation destination for Taiwanese investors not only because of low cost attraction, but also because or geographical, cultural, and language proximity. The major determinants of TDI in China at national level are market size, labour costs, successful export experience, firm size, and the political environment. The major determinants for TDI in China at regional level are market size, labour costs, infrastructure, cultural differences, agglomeration and the FDI policy.

3.5 Entry modes of TDI

A firm seeking to enter a foreign market must make an important strategic decision on which entry mode to use for the market (Agarwal and Ramaswami, 1992). The entry mode has been the cornerstone of a firm's market entry strategy (Tse et al., 1997). Following the literature review on the determinants of TDI in China, this section aims to review the main entry modes and determinants of entry modes for TDI in China.

Although most of the literature has examined the entry modes of FDI in China, the development of theories explaining the entry modes of TDI in China is still in its early

stages. When considering the culture and ethnical similarity between China and Taiwan, the entry modes of TDI in China could be different from those of other FDI in China.

3.5.1 Types of Entry modes

Concerning the TDI entry mode choices in China, in addition to trade, the material-processed, the assembly, and compensate trade, the most popularly adopted entry modes were WOEs[17], EJVs and CJVs[18] (Lin and Ling, 2003).

Most Taiwanese companies went to China in their early stages by sending materials for processing, parts for assembly, samples for further processing and compensation trade (Lin and Liang, 2003; Wang, 2004). WOEs came next and EJVs and CJVs came last (Luo, 1995; Pan, 1996; Lin and Liang, 2003). An increasing number of Taiwanese firms have tended to adopt WOEs, EJVs and CJVs as their priorities recently because the Taiwanese government has gradually allowed TDI into China.

A recent research by Lin and Liang (2003) found that 45.3% of sample companies adopted WOEs while investing in China. Among the others, 31.2% and 23.5% of firms utilized majority and minority equity investment, respectively. Furthermore, WOEs were popularly used in these industries such as rubber (66.80%), electronic (62.60%) and bio-chemical (57.10%). Majority ownership was adopted by steel (5%), telecommunication and cable (66.7%) and security (66.7%) industries.

Except the three major entry modes, Lin and Liang (2003) also suggest that franchising has become a very popular entry mode over the past few years for TDI in China. Franchising has been widely adopted in both Taiwan and China in the past few years. There were 1,126 companies, covering 226 different industries, operating in 64,066 stores and creating US 38 billion dollars in Taiwan in 2000. In contrast to Taiwan, 1,800 firms

[17] Lin and Liang (2004) term the WOEs as wholly owned subsidiaries.

[18] Lin and Liang (2004) term the CJVs as strategic alliance.

had 26,000 stores that altogether created US 250 billion dollars in China by the end of 1999.

3.5.2 Determinants

A literature survey shows that important determinants for entry modes of TDI in China include firm size, industrial characteristics, the political environment, the environment, physical distance, FDI motives and the FDI policy. This section reviews the determinants of entry modes of TDI in China as follows.

(1) Firm size

Firm size is an important determinant for entry modes of TDI in China. Chen and Chen (2002) found that Taiwanese firms are keenly interested in forming strategic alliances with larger reputable foreign firms, but that they have no particular interest or ability in forming horizontal alliances aimed at controlling competitive uncertainties. Through asymmetric alliances, Taiwanese firms gain access to new markets and new technologies. Chen and Chen (2002) also found that TDI from large firms are more likely to engage in EJVs than from small firms.

(2) Industry Characteristics

Determinants for entry modes of TDI in China may vary by industry characteristics. For example, determinants in the analysis of local market situations for TDI in the local real estate market are population, climate, transportation, land costs, building costs, other costs, and the rental level (Hsieh, 1997). Another study by Chen et al. (2003) suggests that determinants of entry modes for Taiwan's Venture Capital firms in China include *guanxi*, risk management, system establishment, economic outlook, regulatory framework, and foreign exchange control.

(3) Political Environment

Similar to FDI policy, the political environment also plays an important role in determinants of entry modes of TDI in China. In overseas investment environment analysis for TDI, both WOEs and CJVs are more sensitive to political change in this confrontational atmosphere. The political confrontational situation between China and Taiwan leads to this phenomenon (Hsieh, 1997).

Hsieh (1997) also suggests that Taiwanese investors involved in three major entry modes, including EJVs, CJVs, and WOEs, are more cautious in the initial country-site selection than they are in subsequent decisions regarding city-site selection.. Hsieh (1997) suggests that this degree of direct cooperation is smaller in WOEs, relatively larger in EJVs, and even greater in CJVs. This study suggests that the smaller the degree of direct cooperation with local partners of the venture, the more easily can investment be withdrawn in cases of political crises.

(4) Physical Distance

Empirical result from Lin and Png (2003) shows that TDI in China is more likely formed as joint ventures if monitor costs increase with physical distance. TDI in China with a project that were located 1000 kilometers further away was 13-17% more likely to be formed as a joint venture.

(5) FDI Motives

Lin and Liang (2003) suggest that determinants for entry modes of TDI in China also vary by the FDI motives of the source country. Taiwanese firms tend to adopt WOEs or majority investment when their operation is involved with know-how transfer and specific asset commitment. If Taiwanese firms aim for local market expansion or resource acquisition, they prefer to build a joint venture. Franchising based on successful formula developed in Taiwan could be one of the best alternatives in the near future as the local market demands start to grow for various industries (Lin and Liang, 2003)

(6) FDI Policy

Chinese FDI policy also plays an important part in the entry modes of TDI in China. For political considerations, Taiwanese investors received preferential treatment in China. The Chinese government considered Taiwan to be a province of China rather than a foreign country. Also, China aims to foster good *guanxi* with the Taiwan business community in order to advance the cause of eventual re-reunification (Sung, 1992). The special FDI incentives offered by the Chinese government to Taiwanese investors, include an unrestricted choice among EJVs and CJVs, and WOEs, no limit on the duration of JVs, and no limitations on sectors of investment (Lin & Png, 2003).

In summary, the theories explaining the entry modes of TDI into China are still in their early stages. Further study in this field will be required. The important determinants for entry modes of TDI in China include firm size, industrial characteristics, the political environment, the physical distance, FDI motives and the FDI policy.

3.6 Conclusion

The Open Door policy and outstanding performance in economic growth in China since 1979 have formed a strong pull force to attract foreign investors in all around the world including Taiwan (Hou, 2002). Confronting the attraction of the China market and the challenge from the deteriorating investment environment in Taiwan, Taiwanese firms have increasingly rushed into China since the end of the 1980s. TDI has been concentrated in China since the middle 1990s but there is an argument that investment in China is potentially more harmful to domestic employment than FDI in the other regions.

TDI in China can be characterized by rapid growth, a large volume in aggregate but with small individual size, its export-oriented and labour-intensive investment, its statistical bias as well as the geographical concentration of industry in coastal areas.

The Taiwanese government efforts to curb and regulate this trend have been belated and only partially successful. The Taiwanese government still maintains restrictions on the

amount and types of the investment projects Taiwanese firms can engage in China. With or without government approval, Taiwanese firms have been actively pursuing its business in China (Siu et al., 2003).

A literature survey has found there is a growing interest on determinants of FDI flows in China, however, studies on TDI in China have been limited. This chapter reviews current Taiwanese and Chinese economic relations and trade/investment policy regarding cross-Strait trade and investment, and then follows this with an analysis of the motives, characteristics, entry modes and determinants of TDI in China. As TDI's locational choices has important policy implications for policy makers in China and Taiwan, my present empirical study will focus on the determinants of locational choices of TDI in China.

Chapter 4 The Subcontracting System and TDI

4.0 Introduction

It is a well-known fact that the East Asian economies have rapidly developed intra-regional trade relationships since the early 1980s. The subcontracting system is built under the intra-firm, intra-regional trade and industrial relationships. Following on from the literature review of Taiwanese direct investment (TDI) into China in chapter 3, this chapter explores the role of the Taiwan's subcontracting system on TDI.

This chapter aims to answer four questions. First of all, what are the features of the subcontracting system in which the Taiwanese firms are involved? Second, what is the role of SMEs in the development of Taiwan's economy? Third, what is the relationship between the subcontracting system and Taiwan's SMEs? Lastly, in what way can the subcontracting system be used to facilitate Taiwanese firms' participation in FDI in China? This paper sets out to explore these issues in the context of the subcontracting system's industrial structure and its effects on the locational choices of TDI in China.

Section 4.1 explores the motivations for this study. Section 4.2 provides an overview of the subcontracting system. Section 4.3 explores the relationship between SMEs and Taiwan's economy. Section 4.4 explores the relationship between the subcontracting system and TDI. Section 4.5 concludes this chapter. Finally, the insights derived from this chapter will be used for the subsequent analysis and discussion of the findings of my econometric model throughout Chapter 7 and 8.

4.1 Motivations

The rapid economic growth of the Newly Industrializing Countries (NICs) in East Asia has been a focus of interest for academics and policy makers for two decades. The bulk of the research in this area focuses on key features shared by these countries, such as the

strong export-oriented industry and their high rates of capital investment (Kumar, 1996). A recent study from Aw et al. (2003) suggest that a number of recent studies based on aggregate and sectoral level data have focused on the role of productivity growth and capital accumulation as determinants of this growth. Krugman (1994), and Rodrik (1995) are among the many researchers that emphasize capital accumulation while others, including Page (1994) and the World Bank (1993) emphasize productivity growth as the principal source of success in these East Asian countries.

Empirical studies, however, have reported mixed findings on the role of MNEs from developing countries, especially Asian NICs (Kumar, 1996). It has also been frequently noted that across these countries there are a number of significant differences in the organization of their industry and the ownership structure of their firms. For example, in the case of the most prominent East Asian NICs, Taiwan and Korea, the manufacturing sector in the former is dominated by small and medium-sized enterprises (SMEs) while Korea's large business groups control most manufacturing output (Aw et al., 2003).

Also, there is a growing literature on the role of Japanese industrial structures on its economic development and FDI (e.g. Kimura, 2001; Solis, 2003; Ando and Kimura, 2003). Up to the 1980s, a major aspect of Japan's international economic success had been its industrial firms' ability to develop a system of subcontracting with large downstream assemblers and upstream SMEs under long-term relationships (e.g. Nishiguchi, 1994; Ando and Kimura, 2003). However, the literature on the relationship between the Taiwanese industrial structure and TDI, in particular, has been limited. This chapter, therefore, aims to explore Taiwan's subcontracting system of industrial structure and its role on the TDI flows into China.

4.2 An Overview of Subcontracting System

This section will first review the definition of the subcontracting system, and then will follow this with an analysis of the the features of the subcontracting system.

4.2.1 Definition of Subcontracting System

Recent research highlights the importance of relationship-based resources on relational assets or social capital (Chen & Chen, 1998; Dyer & Singh, 1998; Nahapiet & Ghoshal, 1998), such as the relation based in a firm's network of relationships with other organizations including firms, governments, and joint venture partners (Choi & Beamish, 2004; Doh et al., 2004; Huang et al., 2004).

The relationships that a firm develops and maintains with others are a significant source of competitive advantage. Key resources for Taiwanese firms diversifying internationally are strategic network linkages developed with other domestic and foreign firms (Chen and Chen, 1998; Huang et al., 2004).

Florence[19] (1997) describes this kind of business network as 'under the intra-firm and intra-industry system, the various types of firms are linked together within a "dynamic network", that provides diversity and flexibility to the industry'. According to a framework suggested by Miles and Snow's (1978), firms differentiate employment systems on the basis of tasks differentiation within a given industry, so that the functions performed in the traditional, professional and commitment systems are different and complementary. Harrison (1994) notes the disintegration of the large bureaucracy and the emergence of network forms of organization based on smaller production units (Florence, 1997).

Many studies term inter-organizational relationships as used informally without formally defining them. Lehtinen (2001) notes that formal definitions of the term "subcontracting" are surprisingly rare. For example, Ando and Kimura (2003) also acknowledge that although the importance of subcontracting networks in East Asia seems to be taken for granted in the business community, even if its existence has not yet been fully recognized in the academic literature. Even though the new manufacturing paradigm that emphasizes outsourcing, cooperation and agility is much discussed on the general level, very little

[19] See http://www.ilo.org/public/english/bureau/inst/papers/1997/dp95/ch1.htm.

empirical research has been done into these issues. A few studies (Lehtinen, 2001; Dragonetti et al., 2005) suggest that most research simply does not define subcontracting. Lehtinen's (2001) research also shows that "subcontracting" has had different meanings depending on its industrial history and evolution. Lehtinen (2001) suggests that subcontracting is still quite often considered as a form of exploiting small firms rather than as a modern way of organising manufacturing. However, this special characteristic of subcontractors as manufacturing service providers is seldom highlighted.

Many economists (e.g. Williamson, 1985; Lewis & Sappington, 1991; Smitka, 1991; Nishiguchi & Brookfield, 1997; Taylor & Wiggins, 1997) have used the term, 'subcontracting', as a general term designing a procurement system or a set of behaviors between buyers and sellers.

Other researchers define "Japanese subcontracting" as such practices as long-term commitment, few suppliers, small lots and little inspection (Williamson, 1991; Taylor et al., 1997). Under the definitions by Williamson (1991) and Taylor et al. (1997), subcontracting is viewed as a generic alternative to in-house production, in an equivalent sense to "contracting" (Dragonetti et al., 2005).

Lehtinen (2001, p35) defines the subcontracting system as, "the supplier network of a prime contractor that includes all direct and indirect subcontractors", and subcontractor as, "company or independent organisation that is responsible for offering subcontracting and related functions to other actors of the chain on a long-term basis."

Subcontracting and the subcontracting system concept have been commonly used in the context of Japanese industry. Asanuma (1989) notes that the Japanese law on "Promotion of Subcontracting Small and Medium Enterprise" (1970) has defined parent firms (e.g. prime contractor) and subcontracting enterprises (*shitauke*) or co-operating factory (*kyoryoku kojo/gaisha)* based on the size of companies. Asanuma (1989) suggests that a subcontractor has been considered as being smaller in terms of capital and number of employees than a parent company. Purchased items have been commonly divided into

two categories: purchased goods (*konyuhin*) and ordered goods (*gaichuhin*) that often correspond to the term subcontracting (Asanuma, 1989).

In addition, financial links are sometimes observed. Kimura (2001, p8) notes that statistically, the Ministry of International Trade and Industry (MITI) and the Government of Japan (GOJ), define subcontracting as:

"A contractual arrangement between a firm and a 'parent' firm with larger capital or larger number of employees. The former firm is commissioned to produce products, parts, attachments, materials, or components used as inputs in the parent firm's production, or to produce or repair facilities, equipment, tools, and others which the parent firm uses in production. When a firm purchases non-customized parts, components, and others through a usual marketing channel, it is not regarded as subcontracting. In subcontracting, a parent firm orders the work directly to a subcontractor with assigning a plan, quality, spec, form, design, or others".

Although the formal definitions of the term "subcontracting" are surprisingly rare, personal observation suggests that the Japanese MITT's official definition of the subcontracting system is closer to the features of Taiwan's subcontracting system. The next section will then review the features of the subcontracting system under this definition.

4.2.2 Features of the Subcontracting System

It has been argued that the subcontracting system is unique in East Asia. Existing literature, however, agrees that the subcontracting system plays an important role in the East Asian economic development.

A growing literature (Uekusa 1987; Helper, 1990; Floerence, 1997; Kimura, 2001; Ando and Kimura, 2003; Soesastro, 2005) suggests there are a few features that can be found in the subcontracting system: 1) an arrangement based on long-term intra-firm relationships

with suppliers from SMEs, and fewer clients; 2) a great deal of information exchange, joint problem solving, risk sharing and; 3) governance by trust.

By reviewing the features of the subcontracting system, we can then explain the relationship between the Taiwanese subcontracting system and the TDI flows into China.

(1) Intra-firm Relationships

The subcontracting system consists of both an intra-firm geographical extension and inter-firm relationships (Ando and Kimura, 2003; Soesastro, 2005). Spiegel's (1993) research shows that except for the vertical subcontracting system, horizontal subcontracting agreements between rival firms, each of which is capable of producing and marketing its products independently, are common. Therefore, both horizontal and vertical integration structure can be found in subcontracting systems varying by industry.

A similar subcontracting system structure can be found in other countries, such as the core-periphery industrial structure in America and Italy. For example, Florence (1997) asserts this core-periphery industrial structure can develop at two levels: direct employment relations and inter-firm trading relations. There are three features for this industrial structure: 1) firms' employment and trading practices reveal core-periphery strategies from the perspective of a given firm; 2) firms' employment characteristics highlight the impact of core-periphery strategies from the perspective of inter-firm differences in employment systems and 3) labour market characteristics highlight the impact of core-periphery strategies from the perspective of the workforce. Large-scale surveys show a segmentation of the American workforce that can be conceptually tied to firms' core-periphery strategies (Florence, 1997).

Florence (1997) notes that the existence of core-periphery strategies in Japan's manufacturing, Italy's industrial districts, and America's high tech industries is of special significance because these industries have inspired much of the literature on the emergence of the commitment system as a new organizational model.

(2) Long-term Relationships

Most studies suggest that the subcontracting system is based on long-term relationships and arrangement (e.g. Uekusa, 1987; Smitka, 1990; Okano and Bonzemba, 1997; Kimura, 2001; Dragonetti et al., 2005). Aoki's (1990) study suggests that the interdependence between assemblers and suppliers is so strong that it was referred to as '*guanxi* integration'. Smitka (1990) suggests procurement in Japan is based on long-term "strategic" partnerships rather than short-term contracting. A recent study (Dragonetti et al., 2005) indicates that the strong relationships with suppliers and the technological uncertainty are the most important determinants influencing the subcontracting decision. Lehtinen (2001) also notes that a one shot transaction, therefore, cannot be called a subcontracting arrangement.

Compared with the subcontracting system between European countries and Japan, the main difference is that the Japanese subcontracting system does not count occasional purchasing as subcontracting. In addition, the long-term relationship is sometimes expected to include risk-sharing arrangements, technology diffusion mechanisms, and a distinctive subcontractor control, such as the "*kanban* system" (Uekusa 1987; Kimura, 2001). Taylor and Wiggins (1997) also suggest that two fundamentally different subcontracting systems arise as distinct solutions to the quality control problem facing an input buyer: 1) The 'American' system involves competitive bidding on each contract, large orders, and inspections; however, 2) the 'Japanese' system involves repeat purchases from a supplier who earns a premium, small orders, and no inspections.

The major motivation for a subcontractor to serve its major clients is the repeat orders from its long-term clients, which is also another important feature in the subcontracting system. Besides repeat orders from long-term clients, the profits are higher for the group that is involved in the subcontracting system, compared with a suppler or an outsourcer. Kimura (2001) found that the probability of working as a subcontractor, a choice made by a many small firms in Japan, is negatively related to size, foreign sales and technological capability (Kimura, 2001).

(3) Between MNEs and SMEs

Most studies (e.g. Nishiguchi, 1994; Kimura, 2001; Ando and Kimura, 2003) agree that the subcontracting system is built between MNEs with large downstream assemblers and upstream SMEs, although some studies suggest particular subcontracting conditions (e.g. Sacchetti & Sugden, 2003) may occur in the subcontracting system.

Suppliers do not always work only with other members of the same group. In fact, there are many cases of competing automakers' sourcing the same type of parts and components from the same suppliers. In practice, many suppliers are shared among different automakers' groups, Daihatsu and Hino have assembled vehicles for Toyota; and Fuji, and Nissan Diesel have done the same for Nissan. In practice, the web of transaction in the Japanese automobile industry is very complex (Okano and Bonzemba, 1997). Therefore, the arrangement between industrial firms and SMEs' subcontractors is not necessarily an exclusive one; a subcontractor may have multiple clients[20]. For example, Logitech Taiwan has supplied customized products for IBM and HP[21]. A recent research from Yasuda (2005) shows that although subcontracting to only one company has no significant effect on a firm's growth, it has a significant positive effect on a firm's survivability.

SMEs play an important role in subcontracting system. In Japan's experience, since the 1970s, the Toyota production system has been dealt with as a synonym for an efficient entrepreneurial network, which is formed by huge numbers of SMEs (Tayanagi and Colovic, 2003). The well-known role of Japanese SMEs' agglomerations, such as Toyota City, is the formation of hierarchical subcontractor networks as a part of the so-called *keiretsu* system (Asanuma 1989;Gerlach 1992; Tayanagi and Colovic, 2003).

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[20] Personal observation from Taiwan also confirms that a subcontractor may have multiple clients. However, some subcontractors may refuse to cooperate with clients not in the subcontracting chains. For example, some textile manufacturers only serve 3 major clients as long term *guanxi*-ties. Some manufacturers even refuse to take new orders from other clients not in the subcontracting system. Also, some subcontractors in Taiwanese SMEs only work for one client.

[21] I had been a project manager in Logitech for a few years. IBM and HP are competitors in the PC industries but Logitech Taiwan supplied customized products to both companies.

Other researchers also agree SMEs are important in the subcontracting system. For example, Ogawa (2002) found that monetary contraction decreases the inventories of large firms; however, inventories of SMEs increase considerably for the first several quarters. This implies that in a subcontracting system, SMEs serve as a buffer and alleviate the monetary shocks felt by their large parent firms. Moreover, inventory build-ups are financed by increases in accounts payable. Therefore, SMEs' land asset is important in easing credit conditions and increasing inventories (Ogawa, 2002).

(4) Significance of East Asia

Okano and Bonzemba (1997) suggest that although this subcontracting is a characteristic of manufacturing companies worldwide, many studies have shown that the Japanese automobile industry is characterized by a higher rate of subcontracting than its Western counterparts (e.g. Odaka et al., 1988; and Smitka, 1991). Japanese suppliers usually produce a complete subsystem of components; they have greater asset specificity and are customer concentrated (Nishiguchi, 1994).

The subcontracting system is not only important in the Japanese economy, it is also important in East Asian economic development. Nishiguchi (1994) suggests that subcontracting can be described as the evolutionary product of a complex historical interaction among social, political, technological, and company-level strategic plans, but not constrained by culture. This makes it possible for other countries to use the subcontracting system similar to those employed in Japan. Kimura (2001), therefore, suggests that other countries, such as Taiwan and Korea, also have subcontracting, though the historical background and detailed structure are somewhat different owing to different initial conditions.

Ando and Kimura (2003) assert that the international production/distribution networks consist of vertical production chains and distribution networks extended across a number of countries in East Asia, which are "unique". Although the formation of similar networks is observed between Germany and East Europe and between the US and

Mexico, the one in East Asia is "unique" at least at this moment in time due to the following characteristics: 1) they have already become a substantial component of each country's economy in the region. Each country's manufacturing sector and international trade cannot be discussed without the existence of the networks anymore; 2) the subcontracting networks involve a large number of countries at different income levels. Cross-country differences in factor prices and other location advantages seem to be effectively utilized in the formation of vertical production chains; 3) the networks include both intra-firm and arm's-length relationships, partially across different firm nationalities. Under this circumstance, MNEs as well as indigenous firms in each country are forming sophisticated inter-firm relationships in East Asia (Ando and Kimura, 2003).

A recent study from Soesastro (2005) also suggests that in East Asia the trade pattern is no longer simply one-way trade based on international differences in resource endowments. Rather, sophisticated vertical production chains as well as distribution connections are extended to region-wide networks. The networks consist of both intra-firm geographical extension and inter-firm business relationships.

(5) Risk Sharing

It has been argued that whereby a firm can shift risk to less powerful subcontractors. The term subcontracting is used to characterize a specific behavior, whereby a firm smoothes its production volume, thus shifting risk to less powerful subcontractors (Berger & Piore, 1980; Elger & Smith, 1994).

Although the prevalence of subcontracting in Japan has traditionally been ascribed to the risk shifting behavior of manufacturers, a dissenting view from Kawasaki and McMillan (1987) suggests the following. First, the subcontractors are risk averse. Second, the contractors have the principal of absorbing some of the risk on behalf of the subcontractor. Third, the price adjusts more to changes in the subcontractor's productions (i) the more risk adverse the subcontractor is; (ii) the bigger the fluctuations in costs are; and (iii) the less severe the moral hazard is. Thus, the contracts in use in Japanese

subcontracting can be interpreted as resolving the principal-agent trade-off between risk sharing and moral hazard.

Other studies (Asanuma & Kikutani, 1992; Yun, 1999) also suggest that these firms seem to be absorbing risk on behalf of the subcontractors. For example, Asanuma & Kikutani's (1992) field research has elicited the following. First, in transactions with those suppliers with whom a manufacturer maintains longstanding relations, each typical manufacturer absorbs risks to a non-negligible degree. Second, the degree tends to be higher (1) the larger the share occupied by the manufacturer is in the total sales of the supplier; and (2) the more rudimentary the category of the item transacted is as viewed from the evolutionary paths of the suppliers.

Dragonetti et al., (2005) assert that the degree of risk sharing between firms and subcontractors is empirically cumbersome, as it requires researchers to know the details of the subcontracting relationship, and the competence level of each of the two parties.

4.3 SMEs and Taiwan's economy

Ernst (1997) suggests that SMEs in Taiwan are engines of growth and industrial transformation sets, which is very different from that of South Korea where highly diversified conglomerates (*chaebol*) have been the main carriers of the development in the electronics industry in that country. Existing studies (San, 1992; Lin, 1995; Aw et al., 2002; McLenahan, 2002; Yang et al., 2004; Huang et al., 2004) agree that the Taiwanese economy is still dominated by SMEs characterized by heavy dependence on subcontracting relations.

Why do SMEs from Taiwan undertake risk in other countries, particular in China? SMEs from Taiwan generally must have strong investment motivations or firm-specific advantages to overcome their disadvantages in the Chinese market, especially the lack of diplomatic ties to protect their economic interests because of the tension between the two sides of the Taiwan Straits (Huang et al., 2004).

This section will first explore the definition of Taiwan's SMEs and then will follow this with an analysis of the features of Taiwan's SMEs.

4.3.1 Definition of SMEs

APEC Industrial Science & Technology Internationalization Database notes that there is no generally agreed definition of SMEs. Each organization has derived their own definition of SMEs for convenience in their work. The various administrative organizations, which deal with the SMEs classify SMEs based on measures of fixed assets, registered capital, sales or number of employees. In Taiwan, a SME is defined by sector, paid-in capital and annual turnover, and the number of employees (See Table 4.1).

Hall & Harvie (2003) also note the definition of an SME varies by country. For example, the upper limit for an SME in manufacturing in Korea is 300 people employed, and in Taiwan is 200 people employed. For commerce and services, the upper limit of an SME is larger in Taiwan, at 50 employees, than in Korea, at 20 employees (Hall & Harvie, 2003). Taiwan does not usually distinguish between small and medium firms in its statistics. Although these may seem like substantial differences, most SMEs employ less than 10 people. In APEC generally, about 70% to 80% of SMEs employ less than 5 people (APEC 2003). There is only a very small percentage of firms, typically ranging from about 1% to about 4%, which have more than 100 employees (Hall & Harvie, 2003).

The share of Taiwan's SMEs in the overall economy is very high, but varies over time. One reason is because the official definition of SMEs has changed several times since 1967 (Wu, 1999). The latest definition (MOEA, 2000; S.M.E.A, 2004. p.31 and p342) is:

"for the manufacturing, construction, and mining and quarrying sector, a SME is a firm with a paid-in capital not exceeding 80 million NTD (an equivalent of 2.37 million USD) and an employment not exceeding 200 regular workers; for the commercial, service, and transportation sector, a SME is a firm with an annual turnover not exceeding 100 million

NTD (an equivalent of 2.96 million USD) and fewer than 50 employees" (MOEA, 2000; Wang, 2005).

Table 4.1 Taiwan – A Definition of a SME

	Employees	Operating revenue	Paid up capital
Manufacturing, construction, mining and quarrying	<200		<NT 80 million
Commerce Transport and other Services	<50	<NT100 million	

Source: S.M.E.A., 2004, p. 31 & p342; http://www.moeasmea.gov.tw/; Hall & Harvie, 2003; Wang, 2005

4.3.2 Features of SMEs

A few significant features of SMEs in Taiwan are identified as: 1) vital role in Taiwan's economy; 2) the lower cost of entry and exit; 3) major players in the subcontracting system; and 4) major players in the center-satellite program.

(1) Vital role in Taiwan's economy

Many scholars (e.g. Hymer, 1976; Chen, 1992; Pont, 2000) generally believe that SMEs in comparison to large firms are at a disadvantage in FDI. However, new evidence from Kuo and Li (2003) suggests that Taiwan's SMEs also play a vital role in its economic development and outward FDI. Another recent study from Veselka (2005) also shows that Taiwanese SMEs are playing a decisive role in technology assimilation and in the implementation of further technological advancements because of their entrepreneurial characteristics.

Taiwan's GNP grew at an average of over 8% per year since the early 1960s to the early 1990s. Aw (2002) suggests that two key features characterize this rapid and sustained growth: an export-oriented trade regime and a market structure based predominantly on

SMEs. The export-oriented regime has been part of Taiwan's industrial strategy since the late 1950s while the preponderance of SMEs began around the same period and persists through to the present day (Aw, 2002).

Existing studies agree (e.g. Ernst, 1997; Addis Ababa, 2001; Hall and Harvie, 2003; Yang et al., 2004; Wang, 2005) that Taiwan has built much of its economic success on SMEs. The contribution of transnationals has been relatively small in Taiwan; it accounted only for 2.2 per cent of the total domestic capital formation in the 1960s and 2.5 per cent in the 1980s. Taiwan's explosive growth in industry is largely attributed to the local SMEs (Addis Ababa, 2001).

In the year 2001, there were 1.1 million SMEs in Taiwan, which amounted to 98 per cent of the total of Taiwanese firms (Wang, 2005). In the year 2001, SMEs provided 80% of private sector employment in Taiwan's economy, which is higher than the APEC average of around 60%. SME performance is an important economic and social issue in Taiwan (Hall and Harvie, 2003). In 2003, almost 98% of the approx. 1.2 million enterprises were classified as SMEs, which realised 31.5% of the total sales, and employed 77.5% of the workforce. Besides, SMEs accounted for 99.4% of the 112,154 newly established enterprises in Taiwan. Therefore, SME performance is an important economic and social issue for Taiwan (Veselka, 2005; Hall & Harvie, 2003; Wang, 2005). Wang's (2005) study asserts that SMEs are the engine for Taiwan's industry and the backbone for Taiwan's economic growth. Taiwanese SMEs are best known for their flexibility, diligence, thrift, highly entrepreneurial spirit, strong adaptability and spirit of teamwork. Collectively, Taiwanese SMEs are reputed as 'a grand army of ants', while Taiwan is saluted as a 'boss island' (Wang, 2005).

Table 4.2 Number of SMEs in Taiwan, 1984-2004

Year	Total	Agri-culture	Mining & Quarrying	Manu-facturing	Elec-tricity, Gas & Water	Construction	Wholesale, retail and Food and Beverage Processing	Transport, Storage & Comm.	Financing, Insurance, Real Estate & Business	Commerce	Others
1984	719,440	21,344	1,193	120,981	38	18,525	442,377	35,157	21,974	...	57,851

-	-	-	-	-	-	-	-	-	-	-	-
1986	737,350	4,221	1,324	129,690	110	21,838	449,005	44,257	18,471	...	68,434
-	-	-	-	-	-	-	-	-	-	-	-
1991	825,556	3 ,121	1,391	154,077	212	31,627	496,992	35,030	31,455	...	71,651
-	-	-	-	-	-	-	-	-	-	-	-
1994	932,852	6 ,945	1,546	153,473	329	56,527	548,150	32,207	17,463	35,357	80,855
1995	991,615	11,702	1,541	154,367	376	62,899	585,445	33,793	19,844	37,698	83,950
1996	1,003,325	11,444	1,474	150,806	394	64,911	598,266	34,174	19,249	38,822	83,785
1997	1,020,435	12,833	1,418	147,507	420	66,619	615,506	32,218	19,529	41,309	83,076
1998	1,045,117	12,933	1,406	145,281	566	70,988	632,444	31,935	20,031	44,108	85,425
1999	1,060,738	12,823	1,392	142,686	624	74,282	642,196	32,415	19,362	46,640	88,318
2000	1,070,310	10,686	1,362	141,340	629	77,093	646,312	31,441	19,163	51,279	91,005
2001	1,078,162	10,622	1,307	137,551	690	76,670	651,841	31,530	18,967	54,783	94,201
2002	1,104,706	10,649	1,350	133,684	1,131	75,840	674,364	31,104	21,585	57,705	97,294

Source: DGBAS, 2003

(2) Lower Cost of Entry and Exit

Aw et al. (2003) suggest that the most significant feature of SMEs in Taiwan is the lower cost of entry and exit. Levy (1991) studied the reliance on subcontracting relationships among Taiwanese producers. This study suggests the presence of a well-developed network of subcontractors in several key industries in Taiwan works to reduce the cost of entry by allowing firms to enter at small scale without a serious cost disadvantage (Aw et al., 2003).

In a field survey, Levy and Kuo (1991) found evidence that firms entering the electronics industry are often characterized by little up-front investment, and that they subcontract the manufacture of a substantial number of components of the finished product. They found that it is not uncommon for firms to have as many subcontractors as employees. The reason behind the numerous subcontractors from SMEs in Taiwan is because the cost of entry and exit is low.

The dominance of SMEs in Taiwan allows firms to enter production with relatively small amounts of capital, thus lowering the sunk costs of entry. Absent from the manufacturing landscape are large companies with big advertising budgets. In fact, there is little emphasis among Taiwan manufactures on brand or product differentiation, thus reducing

the need for such sunk advertising or R&D expenditures by entering firms (Hobday, 1995; Aw et al., 2001).

(3) Major Players in Subcontracting System

Exiting studies (e.g. Ernst, 1995; Addis Ababa, 2001; Aw, 2002; Wu and Huang, 2003) acknowledge that Taiwanese SMEs are major players in the subcontracting system. Aw's (2002) empirical studies show that entrants (and exits) are concentrated among micro to small firms, and that the rapid growth of the value of subcontract services in the manufacturing sector of Taiwan between 1981 and 1991 was also increasingly concentrated among firms in the same size category (Aw, 2002).

In Taiwan's experience, increasing numbers of SME manufacturing firms are concentrating on specific areas of Taiwan and setting up numerous clusters all over the island, some of which are located in rural industrial areas. Within such clusters, subcontracting is very common, particularly among relatives and friends in related industries (Aw, 2002). Aw (2002) notes that the firms exchange not only business information but also factors in their production process. The result is a production network. This has been an important element of Taiwan's economic miracle, especially during the 1970s-1990s period of export expansion (Wu and Huang, 2003). Aw (2002) also suggests that the specific feature that much of the evidence points to as being responsible for the flexible and efficient response to global shocks in demand and supply in Taiwan is the preponderance of its dense network of SME subcontractors, which is the subcontracting industrial structure at an intra-firm level. The flexibility of production has been reinforced by this subcontracting system (Aw, 2002).

Taiwanese SMEs from Taiwan have been associated with international intra-firm networks for years as the OEM (original equipment manufacturer) or ODM (original design manufacturer) base. Most Taiwanese SMEs produce OEM and ODM products for international clients or large domestic transnationals. Taiwanese SME firms have relied heavily on foreign technology for their technological learning. FDI and foreign licensing

have enabled Taiwanese SMEs to acquire the initial production capability, producing OEM products. OEM production experiences have helped Taiwanese SMEs acquire design capability, enabling them to move from an OEM to an ODM stage (Addis Ababa, 2001).

The share of subcontracting on Taiwan's economic development is significant (S.M.E.A, 2004). Amsden (1991) suggests that many SMEs in Taiwan are for all practical purposes members of a particular business group, and are independent only for tax purposes. This is especially true in Taiwan's electronics industry with its heavy dependence on international subcontracting and OEM arrangements. Large domestic firms like Acer, Tatung, and Nanya Plastics rely on a variety of the SMEs subcontractors to which they can pass on the different tasks required for the fulfillment of an OEM contract (Ernst, 1995).

In the last few years, European, US and Japanese multinationals have been focusing on developing their core competitiveness and trying to reduce costs. They have been outsourcing part of their production to low-cost suppliers in other countries, leading to the establishment of a large number of subcontracting manufacturing relationships (S.M.E.A, 2004). For example, foreign TNCs like Philips, Matsushita and Logitech have substantial SMEs subcontractors in Taiwan (Ernst, 1995). To some extent, this has become the most common form of international strategic alliance. Therefore, SMEs from Taiwan have been associated with international subcontracting networks for years (S.M.E.A, 2004).

(4) Major players in the CS program

Taiwanese SMEs in the IT sector rely heavily on a close integration with large local IT makers and affiliation of global IT subcontracting (Wang, 2005). Kishimoto (2003) note that Taiwan entered the IT industry in the 1980s by producing monitors and terminals and assembling fake Apple II computers and IBM-compatible machines. By 2000 the industry's total output (including offshore production) had reached US $47bn. Taiwan

now plays an indispensable role in the global PC supply system. In a wide range of PC sub-products it leads the world – making more than half of all monitors motherboards scanners and notebook PCs.

Taiwan's PC cluster lies in the small area between Taipei and Hsinchu. While some high-value components and electronic parts are imported the bulk is supplied by highly specialised small local enterprises. A large number of SMEs subcontractors are engaged in separate production stages of PCs and peripherals. The industry has been able to grow quickly by securing contracts for OEM (Kishimoto 2003).

In 1984 to support the SMEs specialized in electronic equipment and IT products Taiwan initiated a 'center-satellite program' (*zhongwei tixi*) to integrate SMEs around large industrial firms in a flexible outsourcing network which actually promoted the subcontracting network in Taiwan formally (Ernst 1997; Wang 2005). The objective of this program was to eliminate competition and destructive price-cutting practices by encouraging closer interdependent and long-term ties between larger "center" firms (upstream suppliers final assemblers large trading companies) and their "satellites" (especially component suppliers). The CS program was an attempt by the Taiwanese government to copy the Japanese *keiretsu* system. It was run by the semi-official Center-Satellite Development Industrial coordination Center. In each CS system the central plants assumed the responsibility to coordinate monitor and upgrade the operations of their satellite plants. In order to strengthen these links the Taiwanese government provided a variety of financial assistance manpower training and technical engineering assistance to both the central plants and the satellites (Ernst 1997).

In this CS network SMEs acting as satellites are suppliers to the centre plants and SMEs follow the large firms. Around each satellite a multitude of even smaller firms cluster and specialize in one or a few products. As satellites for large firms SMEs have a high orientation towards labour division and specialize in view of their technology and endowments. They can meet market demand efficiently while maintaining a flexible production capacity and they can make entries to new markets as factor prices change

which brings financial and production flexibility. This strength brings dynamism and efficiency into the subcontracting system (Wang, 2005).

4.4 The Subcontracting System and TDI

The previous sections have explored the role between SMEs and Taiwan's economy as well as its subcontracting. This section aims to explain why Taiwan's subcontracting system plays an important role in Taiwanese outward investment.

The subcontracting system is important in TDI for two major reasons: 1) It can explain the unique motive for TDI from SMEs, which clearly distinguishes it from the FDI of oligopolistic enterprises analyzed by Stephen Hymer and Richard Caves, or the Japanese form of direct investment present by Kiyoshi Kojima; 2) It is also an important determinant in TDI at either national or regional level, which can be explained by the agglomeration theory.

The major features of the subcontracting system include: 1) the fact that it challenges the FDI theory; 2) that it is a major motive for TDI, which may cause industrial migration; and 3) that it has had a significant impact on the agglomeration effects of TDI.

4.4.1 Challenges to the FDI theory

Since Stephen Hymer's pioneering contribution (Hymer, 1960 &1976), theories of a firm implicitly assume that only large, diversified multinational enterprises can compete in industries that combine high capital intensity, high knowledge-intensity and a high degree of internationalization. Most literature (e.g. Hymer, 1976; Chen, 1992; Pont, 2000) believes that small firms, by definition, have limited resources and capabilities and are unlikely to possess substantial ownership advantages. The disadvantages of small size for firms are compounded if they come from small countries. Huang (2000) suggest that adherents of the culture-based argument argue that these incurred costs are rather small in the case of Taiwanese firms investing in China. However, large Taiwanese firms enjoy the same cultural advantages as do small firms. Huang (2000) argues that US and

Canadian cultures are rather similar, but FDI by US firms into Canada is dominated by large firms.

Ernst (1997) suggests that small nations are confronted with three types of size-related disadvantages: 1) The small domestic market places tight restrictions on the ability to function as a buffer against heavy fluctuations in international demand; 2) It constrains the development of sophisticated "lead users" that could stimulate innovation; 3) It also limits the scope for technological spill-over and the limited size of the national knowledge and capital base restricts the choice of industries in which such small nations might successfully specialize.

Existing literature suggests that SMEs are at disadvantage in engaging in FDI. Taiwan's experience in the computer industry tells a different story: despite the dominance of SMEs, Taiwan successfully competes in the international market for PC-related products, key components and knowledge-intensive services (Ernst, 1997). Statistics show that most TDI are conducted by SMEs depending heavily on subcontracting relations. Although there are large enterprises in some sectors, they were not the ones that led the outward investment movement (Guiheux, 1998).

4.4.2 A Major Motive for TDI

The subcontracting system tends to encourage internationalization among companies within the industry network, and it is therefore often one of the key motives that led Taiwanese SMEs to engage in TDI (S.M.E.A, 2004). Subcontracting is a long-term relationship and thus has a strong path-dependent nature. With the comfort of long-term commitments, large enterprises have provided technological assistance to SMEs. The long-term relationship has stabilized the financial condition of SMEs (Kimura, 2001). The unique industrial structure in Taiwan has caused an important motive for TDI in China.

Chen's study (1998) found that most Taiwan's FDI is undertaken by SMEs and that it is of a new type because most of the Taiwanese SMEs after undertaking FDI cases their production in Taiwan. In most cases the parent firm that remains in Taiwan provides logistical support for its overseas subsidiary company and this gives the latter an advantage over its local competitors. However, this also opens up the possibility of transferring all the remaining functions in Taiwan to the local subsidiary (Chen, 1988).

During the 1980s the Taiwanese economy had already slowed down its growth due to some macro-economic factors. At the beginning of the 1990s, China's economy showed a rapid and sustained growth, and the overall strength of the country expanded noticeably. Since large companies have transferred their production processes or supplier systems from Taiwan to China, most Taiwanese SMEs have recognized that such a situational change is severe. Under the subcontracting system, Taiwanese SMEs have had no choice but to follow their leaders in engaging in FDI into China. As a result, the serious phenomena of the hollowing-out of industry has struck almost all industrial agglomerations in Taiwan. Therefore, the subcontracting system is a very important motive in contributing the TDI inflows into China. The subcontracting industrial structure in Taiwan has increased both trade and investment flows between Taiwan and China. As a result, most TDI in China is entirely a Taiwanese industrial exodus instead of an individual firm's movement. Chen (1998) terms the rapid localization of direct investment by Taiwanese firms in China as "industrial migration", clearly distinguishes it from the FDI of oligopolistic enterprises analyzed by Stephen Hymer and Richard Caves, or the Japanese form of direct investment presented by Kiyoshi Kojima.

A similar example can be found in Taiwan's CS program. Over the last few years, the Taiwanese government's CS program (*zhongwei tix*) has generated an increasing variety of linkages between SMEs and large firms, linkages that frequently extend beyond national boundaries. Government policies to promote CS networks were particularly successful in accelerating the outward investment of SMEs to Southeast Asia and China. Once a foreign lead company of an OEM subcontracting network had invested in these

regions, this exerted powerful pressure on the Taiwanese satellites to follow suit and to move their production offshore (Ernst, 1997).

In the case of Taiwan's textile industries, when wages and land costs rose significantly in the late 1980s in Taiwan, these pushed some textile companies to move production to China or Southeast Asia. As companies in the upstream segment of the textile industry moved their operations offshore, their downstream customers were forced to follow suit, leading to a comprehensive "industrial migration" of the Taiwanese textile industry. As for the shoe manufacturing industry, it was common practice to collaborate with other manufacturers in order to be able to process large orders such as the subcontracting system practice (S.M.E.A, 2004). This mixture of competition and cooperation, coupled with the importance of economies of scale, resulted in industrial migration, and establish new industry clusters in other countries, which again was due to the subcontracting system.

4.4.3 Agglomeration Effects

The previous section explored the features of the subcontracting industrial structure as one of the major motives for TDI from Taiwan's SMEs into China. Under the subcontracting industrial structure, MNE's vertical integration and intra-firm trade is of even greater relevance on the agglomeration effects of TDI into China. This section further suggests that the subcontracting system is also one of the major factors behind the agglomeration effects on locational choices of TDI in China.

(1) What is agglomeration?

Agglomeration economies, first identified by Alfred Marshall (1920), enable the participating firms to draw upon a common infrastructure, a specialized pool of labour or customers, develop mutually beneficial relations with their suppliers, and learn from local producer associations and their competitors. Hence, the development of industrial zones, export processing or free trade zones, and the deliberate attempts by governments to facilitate industrial districts. Examples of such economic activity in developing countries

abound. They are particularly numerous in those countries now attracting the bulk of new FDI in East Asian, especially in China, South Korea, Malaysia, Indonesia and Singapore (Dunning, 1998a).

The concept of agglomeration at intra-firm and intra-industry level is different from a cluster of firms in the same industry, and has to do with: a geographic concentration of interconnected companies, specialized suppliers, service providers, firms in related industries, and associated institutions in a particular field that compete but also cooperate (Porter, 1990). Porter (1990) finds that a significant part of international trade originates from local agglomerations of firms in a specific sector. Porter explains the effects of agglomeration through the "competitive diamond", a self-enforcing system, that enable firms to find sources for their competitive advantage in their interactions with the local system of sub-suppliers, customers, competitors and the incumbents in which they operate (Porter, 1990).

FDI may tend to cluster in a certain location (sometimes referred to as "agglomeration") perhaps because of linkages among projects, creating incentives to locate close to other firms (Lim, 2001). An example may be the regional groupings of service providers. More suppliers, each producing a different service, will create finer division of labour in intermediate input markets, thus lowering unit costs for final producers (Wheeler and Mody, 1992; Lim, 2001). Alternatively, agglomeration may occur if firms "herd"; uncertain about whether a country is a good location, firms may wait for the success of the first firm (as a signal of underlying national conditions) before entering the fray in a follow-the-leader type scenario (Lim, 2001).

(2) Agglomeration Effects on TDI in China

The governments in East Asia are obviously conscious of the potential role of government in formulating agglomeration economies. This is an extension of the international trade theory with external economies of scale while introducing the concept of "space" from city planning and other academic fields (Ando and Kimura, 2003). In

reviewing agglomeration economies, Ernst (1997) notes that in Asia, three of these newly emerging production networks are of particular importance: 1) those established by the Korean chaebol; 2) those established by Taiwanese producers of PC-related products and components in Southeast Asia and China; 3) and those networks of suppliers of parts and sub-assemblies based in Hong Kong, Taiwan, Singapore and mostly owned by ethnic Chinese.

A recent study by Berry et al (2002) finds that there is strong relationship between agglomeration and the subcontracting system. Tuan and Ng (2002) also found significant agglomeration effects arising from a core-periphery system, especially those from the SMEs. Tuan and Ng's study investigated empirically the spatial location development of FDI in Guangdong in the context of a core-periphery system using firm (micro)-level data. This system is similar to the Taiwanese government's 'center-satellite program' or the Japanese subcontracting system.

Taiwanese subcontracting industrial structure networks in China also play an important part in the agglomeration effects of TDI in China at regional level. Taiwanese SMEs cluster regionally in the Pearl River delta (i.e. Dongguan) and the Yangtze River delta (i.e. Shanghai, Suzhou, Hangzhou, and Ningbo), respectively, forming themselves into two distinct IT outsourcing networks under the subcontracting system. These two regions are the largest Taiwanese IT production sites in China, and they account for up to 30 per cent of Taiwan's annual total electronic equipment and IT products output (Wang, 2004; Wang, 2005).

According to the Taiwanese investment commission data, the average size of Taiwanese investment projects in China grew from less than US$1 million in the early 1990s to US$200 million in 1995, and to over US$300 million in 2000. What is more, the products being manufactured are different now. In the case of the electronics industry, where as initially the products being made in China were mainly low-end peripherals such as keyboards, mouse and computer casings, the Mainland China operations of Taiwanese companies are now manufacturing monitors, motherboards, notebook PCs and even

semiconductors. At the same time, due to the subcontracting industrial structure, the manufacturers of raw materials and intermediate goods have also been moving production to China so as to maintain their links with the downstream products (Wang, 2004).

As a result, there are important policy implications to the Chinese and Taiwanese governments for TDI in China under the subcontracting networks. Subcontracting will also answer the important question of how Taiwanese firms can manage to ensure TDI into China linkages function smoothly.

4.5 Conclusion

This chapter has explored the importance of SMEs, the subcontracting system and industrial agglomerations for TDI. This chapter suggests that the subcontracting system and SMEs play an important part in Taiwan's economic development and its outgoing FDI into China. Subcontracting networks create international production/distribution networks in East Asia, including Taiwan and China, which has also provided a substantial impact on the academic thought on trade and FDI patterns (Ando and Kimura, 2003).

Taiwanese firms started to make substantial TDI in China in 1991. The intangible assets possessed by these firms were related to their ability to conduct small scale and flexible production. The fact that these SMEs were able to conduct TDI is due to their support by an efficient subcontracting production network encompassing a larger number of highly specialized producers. Firms in this subcontracting system are constantly competing among themselves, but they share production and market information that enables them to react quickly and fruitfully to exchange in technology and the market (Perrow, 1992; Hsu and Liu, 2004).

Under the subcontracting system, Taiwanese companies had already got used to working as a team, so when the business environment in Taiwan started to change the industry

network that had existed in Taiwan was able to replicate itself in China. Therefore, most TDI in China is entirely that of a Taiwanese industrial exodus instead of individual firm's movement, which clearly distinguishes it from the FDI of oligopolistic enterprises analyzed by Stephen Hymer and Richard Caves, or the Japanese form of direct investment presented by Kiyoshi Kojima.

This chapter also explains the significance of agglomeration effects arising from subcontracting, especially for SMEs from Taiwan. Subcontracting is not only a motivation for TDI in China, it is also an important determinant of TDI at either regional or national level. The importance of subcontracting impacts on the location choice in China and can be measured by the agglomeration variable, which will be explored in my econometric empirical model in Chapter 6.

Chapter 5 Political Considerations

5.0 Introduction

Chapter 4 notes that the emphasis of the TDI decision on political risk considerations in China is because of the yet-unsolved cross-Strait political tension between China and Taiwan. Mainland China is the primary destination for Taiwan's outward FDI. China hopes that economic ties will ultimately have a transformational impact on Taiwan's politics. However, the relationship between economic interdependence and military conflict remains one of the most active, and hotly debated, research topics in world politics (Kastner, 2005).

In many studies, country risk has been categorized as a location-specific variable. However, Tahir and Larimo (2003) argue that it should be categorized as an internalisation variable. Butler and Joanquin (1998, p602) identify political instability as:

"the risk that a sovereign host-government will unexpectedly change the rules under which business operate".

The OECD (1994) suggests that the frequency of changes in a country's legal policies and bureaucratic/administrative barriers decisively shape investment choices. Most studies have been primarily speculative and so have not quantified the effects of political, fiscal and legal stability on the FDI flows in Central and Eastern Europe (Bandelj, 2001).

Edwards (1990) suggests that political instability plays a significant role in determining the flow of FDI in developing countries. As China and Taiwan are in political conflict, the political instability seems to be more pertinent in this study. However, most studies about China and Taiwan and their political conflict have also been primarily speculative, mostly from media reports, and have not quantified the effects of political, fiscal and legal stability on the TDI flow in China.

In Taiwan, as in many developing countries, politics can affect industries and the economy. Relations between Taiwan and China are paradoxical and contentious. As a small island heavily dependent on exports and trade, Taiwan is particularly susceptible to political relations with China. Business needs a stable environment in which to operate and therefore political stability between China and Taiwan is of great concern to Taiwanese investors. Although business has long played a central role in bilateral relations between China and Taiwan, as long as the Chinese government prepares to unify the territory, politics seems to become more and more significant. In practice, the mutual hostility has not prevented business ties from flourishing. Political considerations to some extent, however, influence the business decisions of Taiwanese investors.

The cross-Strait trade and investment between the two countries are highly unbalanced. China has been the destination for more than 50 per cent of all of TDI, which creating political anxieties in the Taiwanese government over the heavy dependence on the mainland market. A recent study by Chase et al. (2004) suggests that President Chen Shui-bian faces pressure from the business community, KMT and DPP. The business community and the opposition parties, mostly the KMT, demand for a further ease in restrictions on investment, and to pursue the establishment of direct cross-Strait links. Opposition pressure from Democratic Progressive Party (DPP) maintains that increasing economic integration with the Mainland will increase unemployment among grassroots DPP supporters and diminish Taiwan's prospects for political independence (Chase et al., 2004).

This chapter will explore the political relations between China and Taiwan. The first part of the chapter provides an historic review of Taiwan's political development. The second part of the chapter will explore the political factors between China and Taiwan and discusses how this could affect Taiwanese direct investment into China.

5.1 An Overview of Taiwan's Political Development

In 1895, military defeat forced China to cede Taiwan to Japan. Taiwan reverted to Chinese control after World War II. Following the Communist victory on the Mainland in 1949, two million Nationalists fled to Taiwan and established a government using the 1946 constitution drawn up for all of China (Gupta, 2003). Over the next five decades, the major Taiwanese political history can be divided into four main periods: from 1945 to 1986, 1986 to 1996, 1996-2000, and 2000-2004 and after 2004 (Kao, 1992; Klein, 1992; Tien, 1992; So and Chiu, 1995; Schafferer, 2004; Kastner, 2005).

5.1.1 1945-1986

After the Japanese surrendered in 1945, the Kuomintang (KMT; *guomindang* 国民党) on Mainland China took control of Taiwan from the Japanese, who had ruled Taiwan as its colony for fifty years. Four years later, the defeated KMT forces retreated to Taiwan after losing the civil war to the Chinese Communists (Tien, 1992). Although the Taiwanese government had been under the KMT's regime since 1949, the party's final authority was controlled by its two supreme leaders, Chiang Kai-shek 蒋介石 (who ruled from 1949-75) and Chiang Ching-kuo 蒋经国 (who ruled from 1975-87), the elder son of Chiang Kai-shek.

During the 1950s and 1960s, Taiwan's international relations existed under the protection of the America government as in June 1950, the Korean War had forced the Truman government to suddenly change America policy regarding the security and future of the Taiwan Strait. Since then, the Seventh Fleet patrolled Taiwan against any military action by the Chinese Communists (Klein, 1992; Tien, 1992). Under President Chiang Kai-shek's control, the KMT did not pay much attention to Taiwan's development, as he and his followers initially thought Taiwan would be a temporary military and political base for the recovery of the Mainland (Klein, 1992; Tien, 1992).

The KMT government distinguished the Taiwanese (people of the Taiwan province) as *benshengren* 本省人 and the Mainland Chinese in Taiwan (people of the provinces other than Taiwan) as *waishengren* 外省人[22]. Most Taiwanese, however, spoke not Mandarin, but the Minnan dialect (*minnanhua*) and Japanese, which made communication with the KMT officials very difficult and therefore easily caused misunderstanding and conflict. Because Japanese, who ruled Taiwan for fifty years, had heightened the racial and cultural differences between the native Taiwanese and the Mainland Chinese, animosity soon developed between the native Taiwanese community and the KMT government (Li, 1993; So and Chiu, 1995).

Gold (1986) suggests that the KMT took many problems of the Mainland KMT government to Taiwan, such as lawlessness, corruption, gangsterdom, nepotism, and inefficiency. So and Chiu (1995) suggest that during the KMT's reign, there were many events concerned with the mismanagement of the KMT, and that the Taiwanese government was mainly controlled by Mainland Chinese officials (*waishengren*) with very little influence from native Taiwanese (*benshengren*). During elections, for example, only the KMT had the official organization and media for its candidates, and most elections applied only to local, and not to provincial or national executives. The National Assembly was therefore called the "100 year-old National Assembly" (*bainian gouhui* 百年国会) as those representatives were never re-voted by natives of Taiwan. Elections applied to the national and provincial representatives, however, had very little influence on government policy. Thus, due to the Sino-Japanese's wartime damage and the KMT's mismanagement, Taiwan's economy was in a crisis situation by 1946, with fallen production, high inflation, and serious shortages of food and basic commodities (So and Chiu, 1995).

[22] KMT defines people by state administrative units (provinces) and state person-defining procedures (jiguan registration). If someone was born in Taiwan, his or her jiguan is defined as benshengji. If someone was born in any of the provinces other than Taiwan, his or her jiguan is defined as washengji.

On February 28th in 1947, conflicts between *benshengren* and *waishengren* eventually broke out, resulting in the February 28 massacre (*ererba shijian* 二二八事件), which caused the slaughter of up to 28,000 *benshengren* and many more jailed and tortured, many of whom were intellectuals and professional people. After a rebellion against the corrupt and venal regime of Chiang Kai-shek's, the Chinese government started in on Taipei on February 28 in 1947, and it quickly spread to all the major cities in Taiwan. It was quelled after the ruling KMT's troops began a bloody crackdown on the native Taiwanese resistance. It was estimated that at least 20,000 *benshengji* 本省籍 Taiwanese were killed, including senior high school students, university students, university professors, medical doctors, lawyers, or legislators. This event has become the symbol of KMT oppression and therefore widened the gap between the *waishengren* and the *benshengren*. In 1995 President Lee formally apologized for the event, and in 1997 the Taiwanese government declared February 28 as a national holiday of remembrance.[23] Thus a "February 28th Peace Park" was set up. However, to some extent this event has been left to the opposition DPP to dismantle the other trappings of the KMT's past in favour of a more Taiwanese identity that could contribute to the independence of the Taiwanese.

Johnson's (1992) research, therefore, suggests that since 1945, Taiwan has been a more settled society as a powerful immigrant minority took control of Taiwan and created a new social division of labour in which the native Taiwanese were systematically excluded from any higher more desirable positions. Although some forms of competition or conflicts between *waishengren* and *benshengren* are open taboos, nobody is very willing to talk about them (Li, 1989). In reality, since the *waishengji* KMT, as a minority in Taiwan, has been ruling other *shengji* for such a long time, there has been much social or ethnic conflict, as the contradictory subjects in many elections, between *benshengren* and *waishengren* communities have shown (Tien, 1992). Furthermore, the creation of the DPP (Democratic Progressive party; *minjindang* 民进党), traditionally associated with

[23] Taiwan's Legislators passed a draft to turn the "February 28" into a national holiday of remembrance, and the decision was also immediately promulgated by Taiwanese President Lee in an unusually fast manner.

advocating Taiwanese independence, has ended almost four decades of a one-party system in 1986.

The political disagreement between the native Taiwanese and the KMT, Orme (1995) suggests that the two major economic policies that have been implemented in Taiwan were among the most impressive and successful government initiatives in the developing world. Both the land reform policy that was implemented from 1949 to 1953 and the shift to an export-led strategy of economic development from 1958 to 1962 had widespread and beneficial effects in Taiwan, while simultaneously promoting economic growth with social equity and political stability.

5.1.2 1986-1996

The official President, Chiang Ching-kuo, had been increasing tolerance of political diversity in his final years. Before he died in January 1988, he performed a number of remarkable measures of political liberalization. Chiang allowed the DPP to be created in 1986, lifted martial law in 1987, and loosened the control on the press, public assemblies and demonstrations, as well as allowing indirect trade and travel to China through a third place (Kau, 1992; Hsiao, 1999).

Vice President Lee, a native Taiwanese, took over Chiang's leadership position when Chiang died in January 1988. Since then, President Lee has successful transformed Taiwan from an authoritarian regime into an impressive democratic system, which is called the "quiet revolution" in Taiwan's political history. President Lee has been searching for diplomatic recognition from other countries, which to some extent has increased Taiwan's international reputation, but also caused serious concerns from China.

Taiwan has undergone major transformations since the late 1980s. By the 1980s international economic priorities had begun to shift away from labour-intensive industries to high-tech industry. In economic liberalization, Taiwan's currency started to appreciate and therefore the economic growth, especially for labour-intensive industries, began to

slow down. This was combined with declining growth rates, where from 1980 to 1990, the annual growth rate averaged 8.25% (Wu, 1995). In its political relationship with China, in 1994, Taiwan abandoned its formal claim to rule Mainland China, which improved the overall relationship between China and Taiwan.

In Taiwan's internal political democratization, from 1986 to 1996, Taiwan held eight major elections, and each of them contributed to the gradual transferring of political power from the ruling KMT to a multi-party system which competes for control at all levels of government. Furthermore, people in Taiwan started to vote for the governor of the Taiwan province, and mayors for the Taipei and Kaohsiung cities since December of 1994.[24] Besides this, Taiwan held its first direct presidential election in March 1996 and President Lee Teng-hui became the first native-born Taiwanese to become President. He speaks Japanese, the language of Taiwan's rulers from 1895 to 1945[25], better than Mandarin Chinese, the official language of China and Taiwan.

In less than a decade, Taiwan has gradually been transformed from a single-party, authoritarian state into a democracy of multi-party system (Tien, 1996). Although the KMT monopolized political power and public resources, the creation of the DPP in 1986 and scores of other minor parties such as the Labour Party and the Workers' party has since then categorically changed Taiwan's party system (Tien, 1996). Furthermore, the creation of the New Party (new KMT), a KMT splinter-group led by diehard *waishengren,* in 1992 has further challenging the monopoly of power by the KMT. Taiwan has been transferring from a one-party state into a democratic multi-party system: KMT, DPP, and the New Party, all of which could be seen in Taiwan's legislative election in 1995. Furthermore, the first presidential election in March 1996 was directly voted by the Taiwanese, and not through the members of the National Assembly, and became the first Taiwanese democracy in 400 years of Taiwanese history.

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[24]Central Daily News, December 3-10, 1994.

[25] Taiwan was a Japanese colony for 50 years until 1945.

Since 1986, Taiwan's effective political power has gradually swung away from *waishengji* KMT leaders as more *benshengren* have taken over important leadership positions (Chang, 1992). For example, Lee Teng-hui, a native of *benshengren*, won the first direct presidential election in March 1996. Taiwan has moved from a single-party, authoritarian political system, to a more modern democratic system, in which the KMT has relaxed political control to allow more political participation and sharing of political power by a broader segment of the native population (Winckler, 1987).

5.1.3 1996-2000

Taiwan's party system has gradually changed since this island split from China in the 1940s, although the ruling KMT is still in power, and has big stakes in the media, manufacturing, trading, real estate and financial services, with its assets easily totaling over US$8 billion (Tanzer, 1996). However, the KMT's political force is faltering because the KMT has problems in its reputation and image, appearing too close to big business and gang societies. It has had trouble fielding enough attractive candidates.

The important issue in China is the proposal by President Lee that the Taiwan Provincial Government needs pruning[26], which have renewed doubts both in Taiwan and China about the sincerity of Lee's commitment to the reunification of Taiwan and the Mainland. The Chinese government's concerns on this issue are because the whole concept of the Taiwan province is linked to the ideal of the reunification into one China, and so to attack one is to attack the other. It, therefore, has further widened the political gap between the two sides of the Taiwan Strait.

5.1.4 2000-2004

In 2000, Taiwan underwent its first peaceful transfer of power from the KMT to the DPP. The Nationalist party, or KMT, had governed Taiwan for over 50 years, but in 2000,

[26] Since 1949, there have been two central governments in Taiwan: the Taiwan province and the Republic of China (ROC), which compete each other to control the political and economic resources in Taiwan. President Lee decided to prune the Taiwan province.

electors broke with tradition by electing the DPP leader as President. This marked the end of rule by the Kuomintang (KMT) and the beginning of a new era in Taiwan's politics The KMT candidate, then Vice-President and Premier Lien Chan, had to admit a major defeat. Song Chu-yu, who had left the KMT because of its failure to nominate him as the party's presidential candidate, took second place in the presidential election; and soon after formed his own political party, the People First Party (Schafferer, 2004).

Throughout this period, the island prospered and became one of East Asia's economic "Tigers" (Gupta, 2003). After its defeat in the second presidential election in 2000, the KMT, which had dominated power in Taiwan for over 50 years, accepted its defeat and transferred the executive power to the DPP, which had existed for less than 14 years. The transfer of power was peaceful, and multi-party competition has become institutionalized, suggesting that democratic principles and practice have been accepted and honoured by both the political parties and the general public in Taiwan. This is no small political achievement in a society where political power used to be seized and maintained with violence and coercion.

After the peaceful transfer of power from the KMT to the DPP, following the defeat of the KMT in Taiwan's second presidential election, Taiwan has initially consolidated its democracy (Wang, 2001). Schafferer (2004) suggests that Newly elected President Chen Shui-bian faced difficulties in implementing his proposed polices as the parliament was dominated by the 'blue camp,' comprising the KMT, the New Party, and the newly formed PFP (People First Party). In the 2001 elections the DPP achieved a higher number of seats than all the other parties individually, but does not have an outright majority (Gupta, 2003).

Cross-Strait relations initially stabilized after the election of DPP candidate Chen Shui-bian as Taiwanese president in the spring of 2000: at his inauguration, Chen announced that his administration would follow a policy of "5 No's," which included no official independence for Taiwan, no public referendum on the issue of independence, and no change in the ROC's name (Kastner, 2005).

However, Chen's policies toward China have clearly grown more provocative over time, even as outward TDI into China has expanded extremely rapidly since 2001. In 2002, for example, Chen suggested a formula for cross Strait relations—one country on each side of the Strait (*yibian yiguo*)—that closely paralleled the former President Lee's two states theory that had enraged Beijing in 1999. Chen's more recent decision to hold a referendum on issues relating to Taiwan's national security at the same time as the 2004 Taiwan presidential election, and his announced intention to revise the ROC constitution, have likewise been viewed by Beijing as highly provocative (Kastner, 2005).

5.1.5 A Look at the Future (after 2004)

On 20 March 2004, thirteen million people went to the polls to elect the president and vice-president of Taiwan. President Chen Shui-bian and his running mate Lu Hsiu-lien of the ruling DPP won the election by a narrow margin of 29,518 votes. The opposition spoke of a rigged election and asked the court to nullify it. As no evidence was produced to substantiate the claims, the High Court dismissed the case. The election was a further setback for the pro-China forces in Taiwan, and a victory for the localization movement let by President Chen Shui-bian and the DPP (Schafferer, 2004).

Although President Chen Shuibian of the DPP has forsaken his electoral pledge for independence and abandoned the ex-president Lee's rhetoric of "state-to-state" relations, he clings on to the concept that Taiwan is an independent and sovereign country. The DPP activists continue to push their "pragmatic diplomacy" and call for a "Republic of Taiwan". This position is considered unacceptable by the Chinese government and has thus worsened the cross-Strait relations. In the middle of all this tension, the Chinese government has expressed its persistent stance that the issue cannot be dragged on indefinitely, which indicates that time is running short. Hence, the Taiwan issue has posed a potentially explosive challenge to the Chinese nation on both sides of the Strait, and has to be addressed in a sagacious and realistic manner (Feng, 2002).

Despite all the upheavals, a peaceful solution looms imminent, particularly in view of the domestic politics and the economic development across the Strait (Feng, 2002). Economic links therefore still play an important part in easing tensions between the two sides of the Taiwan Straits.

5.2 An Overview of Taiwan and China's Political Relations

Based upon the background of Taiwanese political history, this section will continue the discussion of the obvious political factors that could impact on Taiwanese investors' decisions on the Mainland. China considers Taiwan to be a part of "One China". Taiwan is looking to reach some sort of accommodation with China in what is termed "Cross Strait relations". Hitherto no political solution or formula acceptable to both sides of the Taiwan Strait have emerged.

There have been no actual wars between China and Taiwan since 1945 although the two governments have been involved in political tensions. There have been a few political exercises from China recent years. It has also been argued (e.g. Wang, 2001; Kuan, 2005) whether these military exercises could impact on the overall TDI inflow into China.

In view of Taiwan political development, Taiwan has had an interesting post-war history in terms of its political estrangement from Mainland China (Gupta, 2003). Since the mid-1960s, the cross-Strait relationship turned into a cold-war period in which a stand-off between the two sides continued but without any artillery fights or air/sea wars like those from 1949 to 1965. In 1978, China adopted an 'open door policy' in terms of economic reform. In 1979 China softened its Taiwan policy by initiating the principle of "peaceful unification" and proposing economical and social exchanges across the Taiwan Strait, though still refusing to renounce the use of force against Taiwan. Taiwan, however, did not respond reciprocally until November 1987 when the Taiwanese government announced that it would allow its people to visit their relatives in China (Kuan 1996; Kuan, 2005). Over the next few years the announcement was followed by a series of measures that illustrated the liberalization of Taiwan's China policy and marked the

beginning of a whole new relationship between the two countries. Since then the exchanges of people, goods and capital across the Strait continued to grow steadily. The cold war thus was replaced by détente, and an unprecedented level of cooperation between Taiwan and China occurred (Kuan 1996; Kuan, 2005).

Cross-Strait relations declined drastically throughout the second half of 1995 as Taiwan began to take steps- such as seeking a separate seat in the United Nations - that Chu (2000) has described as "a concerted effort to establish a separate international identity" for Taiwan. In 1995 the détente came to an end when China reacted to the US visit by Taiwan's President Lee with missile tests. Moreover, in 1999, Lee announced "two states theory," which held that Taiwan is a separate entity and that negotiations between Beijing and Taipei should occur as "special state-to-state relations." (Chu, 2000; Kastner, 2005). Taiwan's policies during the 1990s were clearly becoming less accommodating to Beijing's goal of eventual reunification. This crisis turned the two countries' relationship sour and started a series of tensions during the period of mid-1995 to 2004 that like of which had not been seen in the past three decades (Kuan, 2005).

Prior to Taiwan's first presidential election in 1996, China conducted a series of missile tests and military exercises in the Taiwan Strait to demonstrate China's determination and capability to regain Taiwan by force if Taiwan started heading towards independence (Wang, 2001). China undertook missile tests in the sea north of Taiwan in the summer of 1995, and in August and November staged two large-scale military exercises. In the run up to Taiwan's first presidential election in early 1996, the Mainland undertook two more sets of military exercises, along with missile tests only 35 kilometers off the Taiwanese coast (Swaine, 2001; Kastner, 2005). In both 1995 and 1999, Chinese leaders cancelled quasi-official talks scheduled to be held between the two sides, and the Chinese government in early 2000 issued a strongly worded white paper that was highly critical of Taiwan (and that suggested the island's continued delay on reunification would be a legitimate cause of war)[27]. Both episodes are representative of Beijing's general efforts to

[27] Text of PRC White Paper. FBIS-China, 24 February 2000.

signal a resolve to fight a war rather than accept a formally independent Taiwan (Kastner, 2005). Moreover, the change in Taiwan's presidency to the DDP leadership in March 2000 has put the reunification talks on hold (Feng, 2002).

Despite the high level of tension in relations across the Taiwan Strait in 1995, China tried to assure Taiwanese investors that their rights and interests on the Mainland would not be affected. Kastner (2005) suggests that Beijing's signals have continued to emphasize military threats and exercises, rather than taking advantage of the increased opportunity afforded by economic integration to send credible signals by imposing or threatening economic sanctions. For example, Association for Relations across the Taiwan Straits (ARATS) President Wang Daohan told Taiwan investors that "although political relations across the Taiwan Straits are strained, economic and trade cooperation...are not strained and are still developing."[28] Tang Shubei, then executive vice chairman of ARATS, likewise noted that despite tensions, "Taiwan investors' rights and interests on the Mainland are not affected in any way"[29] (Kastner, 2005). Therefore, these military exercises or missile tests in 1995 and 1996 seemed to have no impact on the overall TDI in China (See Table 5.1). The individual remittance or business remittance to Mainland China seemed to be at normal levels in 1995 and 1996 (See Table 5.2 and Table 5.3). The number of Taiwanese visitors to China remained high in 1995 and 1996 (See Table 5.4).

A similar pattern emerged during the 1999 crisis. Following President Lee Teng-hui's "state-to-state" comments in 1999, China launched a propaganda barrage and military activity in and around the Taiwan Strait. Prior to the March 2000 Taiwan presidential election, PRC Premier Zhu Rongji threatened that increased tensions could result if Chen Shui-bian were elected (Report to Congress, 2003). Deputy Director of the Taiwan Affairs Office Li Bingcai remarked, for example, that "no matter what happens...we will continue our unremitting efforts to promote the development of cross-Straits economic

[28] *Xinhua News Agency*, 29 October 1995, in FBIS-China, 31 October:71.

[29] *Zili Wanpao*, 21 July 1995, in FBIS-China, 31 July:90.

relations."[30]. Beijing's signals have continued to emphasize military threats and exercises, rather than taking advantage of the increased opportunity afforded by economic integration to send credible signals by imposing or threatening economic sanctions (Kastner, 2005). Again, there is no negative impact on the overall TDI flows into China. (See Table 5.1). The individual remittance or business remittance to Mainland China both increased significantly in 2000 (See Table 5.2 and Table 5.3).

Table 5.1 Approved Taiwanese Outward FDI , 1994-2002 (unit: US $ 1,000)

Year	China (% on total TDI)	Southeast Asia (% on total TDI)
1994	962,209(37.31)	397,731 (15.42)
1995	1,092,713 (44.61)	326,098 (13.31)
1996	1,229,241(36.21)	587,268(17.3)
1997	1,614,542(35.81)	641,241(14.22)
1998	1,519,209(31.55)	477,494(9.92)
1999	1,252,780(27.71)	522,180(11.55)
2000	2,607,142(33.93)	389,446(5.07)
2001	2,784,147(38.80)	523,339(7.29)
2002	3,858,757 (53.38)	210,863(2.92)

Note: Southeast Asia refers to Malaysia, Singapore, Thailand, Indonesia, the Philippines and Vietnam.

Source: Hsu and Liu, 2004

Table 5.2 Individual Remittances to Mainland China from Taiwan, 1993-2005 (Unit : US$1,000)

Period		Period				1990~ Jan., 2005 Cumulative	
		Cases	Growth rate %	Amount	Growth rate %	Cases	Amount
1993		73,665	-18.41	238,343	16.56	237,476	543,738
1994		99,665	35.29	350,107	46.89	337,141	893,846
1995		104,326	4.68	391,088	11.71	441,467	1,284,934

[30] Official Assures Taiwan Investors of Greater Protection. *Xinhua News Agency*, 9 September 1999, in FBIS-China, 13 September.

1996		107,966	3.49	378,554	-3.20	549,433	1,663,488
1997		113,349	4.99	425,132	12.30	662,782	2,087,620
1998		103,967	-8.28	350,975	-17.44	766,749	2,439,594
1999		122,180	17.52	365,103	4.03	888,929	2,804,697
2000		142,666	16.77	511,050	39.97	1,031,595	3,315,748
2001		172,572	20.96	678,067	32.68	1,204,167	3,993,815
2002		234,946	36.14	941,371	38.83	1,439,113	4,935,185
2003		328,541	39.84	1,405,363	49.29	1,767,654	6,340,548
2004		330,511	0.60	1,978,309	40.77	2,098,165	8,318,857
2005							
	Jan.	45,805	31.19	229,024	77.04	2,143,970	8,547,882

Note:

1. Statistics began in May 21,1990.
2. Figures include household remittance, donation, and other transfer payments.
3. Travelling expenditures are excluded.
4. Growth rate is the year-on-year growth rate
5. The figures are not added up to the total due to rounding up.

Source: Foreign Exchange Department, Central Bank of China, Taiwan.

Table 5.3 Taiwan Business Remittance to Mainland China, 1993-2005 (unit: US$1,000)

Period		Period				1993~ Jan., 2005 Cumulative	
		Cases	Growth rate %	Amount	Growth rate %	Cases	Amount
1993		505	-	15,898	-	505	15,898.00
1994		2,521	399.21	100,397	532	3,026	116,295.00
1995		3,954	56.84	151,676	51	6,980	267,971.00
1996		9,442	138.8	281,658	85.7	16,422	549,629
1997		8,195	-13.21	333,079	18.26	24,617	882,707
1998		10,196	24.42	378,334	13.59	34,813	1,261,041
1999		11,129	9.15	477,485	26.21	45,942	1,738,526
2000		18,301	64.44	697,570	46.09	64,243	2,436,096
2001		26,880	46.88	1,012,726	45.18	91,123	3,448,822

2002		56,121	108.78	1,578,502	55.87	147,244	5,027,324
2003		117,523	109.41	4,671,147	195.92	264,767	9,698,471
2004		192,187	63.53	8,698,955	86.23	456,954	18,397,426
2005							
	Jan	19,643	79.67	856,946	113.16	476,597	19,254,373
Total		469,617	–	18,986,402	–	–	–

Note:

1.Statistics of Taiwan indirect companies remittance began at July 29,1993.

2.Growth rate is the year-on-year growth rate.

3.The figures are not added up to the total due to rounding up.

Source: Foreign Exchange Department, Central Bank of China, Taiwan

Table 5.4 The Number of Tourists to Mainland China from Taiwan, 1988-2005 (Unit: Persons)

Period		Period		Cumulative
		Persons	Growth rate (%)	
1988-1989		978,700	–	978,700
1990		948,000	75.23	1,926,700
1991		946,632	-0.14	2,873,332
1992		1,317,770	39.21	4,191,102
1993		1,526,969	15.88	5,718,071
1994		1,390,215	-8.96	7,108,286
1995		1,532,309	10.22	8,640,595
1996		1,733,897	13.16	10,374,492
1997		2,117,576	22.13	12,492,068
1998		2,174,602	2.69	14,666,670
1999		2,584,648	18.86	17,251,318
2000		3,108,650	20.27	20,359,968
2001		3,441,960	10.72	23,801,928
2002		3,660,570	6.35	27,462,498
2003		2,731,900	-25.37	30,194,398
2004		3,685,310	34.90	33,879,708
2005				
	Jan.	269,500	6.81	34,149,208

	Feb.	347,400	37.41	34,496,608
	Mar.	315,700	11.20	34,812,308
	Apr.	369,200	14.33	35,181,508
	May	369,000	35.84	35,550,508
Total		35,550,508	–	–

Note:

1.Taiwan residents have been allowed to visit Mainland China since November 1987.
2.China Travel Service in Hong Kong has not provided the Monthly data of "The Number of Taiwan People Applied for Mainland China Travelling Visa " since May, 2000. The statistics are replaced by the "Number of Taiwan Tourists to Mainland China" which is from the "China Monthly Statistics" published by The China Statistical Information and Consulting (Beijing) Co. Ltd. since May, 2001.
3.Growth rate is the year-on-year growth rate.
4.The figures are not added up to the total due to rounding up.

Source: China Monthly Statistics and China Travel Yearbook, various issues.

Bolt (2001) draws an interesting conclusion based on his study of economic interdependence across the Taiwan Strait stating that although economic interactions between China and Taiwan are not in themselves leading to a solution of the Taiwan issue, they do contribute to achieving the political compromise necessary for a peaceful settlement (Bolt, 2001; Feng, 2002). At the present, about a third of Taiwan's currency economy is dependent upon trade with the Mainland. In the last twenty years, economic and trade communication across the Strait was developed from zero and boomed to a situation of cross-Strait economical counteractive and mutual benefit (Feng, 2002).

Kastner (2005) suggests that the information effects of economic interdependence can potentially arise through two distinct processes. First, integration into global capital markets can make threats more costly, and hence more credible, by scaring off international investors. Second, economic interdependence, by making it possible to impose costly economic sanctions, gives policymakers a greater range of signals through which to demonstrate resolve without resorting to war. In the cross-Strait context, the argument suggests economic integration reduces the likelihood of war because Mainland

China now has the ability to impose very costly economic sanctions against Taiwan, giving it the capacity to display a high level of resolve; if it weren't for extensive cross-Strait economic ties, Mainland China would have to rely on military force to signal a similar level of resolve (Kastner, 2005).

Nanto (2005) in the CRS report to the US Congress also notes that in economics and trade, both Taiwan and China hold strong leverage over each other. The two economies complement each other and depend on each other for financing, technology, labour, and manufacturing expertise. The fact is that Taiwanese businesses have invested between $70 billion and $100 billion in China, about half of all TDI. About a million Taiwanese businessmen and their families reside in China - some 400,000 in the Shanghai area alone. China has not been as free to invest in Taiwan, but even that is gradually opening up. Nanto (2005) suggests that the political leverage between China and Taiwan: 1) Exists because of the mutual dependency that has developed; China holds Taiwanese businesses in a situation somewhat akin to a "hostage". 2) Taiwan holds its high technological industrial as a leverage over China.

5.3 Conclusion

Relations between Taiwan and China are paradoxical and contentious. For the Taiwanese government, growing TDI into China raises concerns that Taiwan's economy is becoming too dependent on the Mainland. The economic relationship between China and Taiwan has thus become a sensitive issue in Taiwanese politics.

The Taiwanese government believes that Taiwan's growing dependence on Mainland China enables China to gain greater economic, social and even political leverage over Taiwan, affecting Taiwan's national security and upsetting the regional balance (Siew, 2002). Political considerations, therefore, play a role in the TDI flows in China. The Taiwanese government has been concerned about the high technological industries as a major power to balance in the threat from the Chinese government. The variables for

educational levels will be explored in an empirical model in chapter 6 in order to examine the level of technology transfer from TDI into China.

Chapter 6 A Location Analysis of TDI in China

6.0 Introduction

Understanding what determines investment location choices can help inform the consequences of implementing new FDI policy by host country governments as well as provide tools for FDI agencies in these countries to formulate their strategies. Identifying the determinants of the locational choices of TDI in China has significant policy implications for the governments of China and Taiwan, which can adopt measures to either actively solicit TDI flows into China or discourage it.

Following the literature survey of TDI in China in Chapter 3 and Taiwanese subcontracting system in Chapter 4, a conditional logit model will be developed to explain the distinctive locational determinants of TDI in this chapter, providing results that may serve as empirical evidence for local governments in designing TDI policies.

The remainder of the chapter is organized as follows. Section 6.1 explores motivations of this econometric study. Section 6.2 presents research hypotheses of this study. Section 6.3 provides data and limitations, variable measurement, and econometric model. Section 6.4 reviews estimation results of this study. Section 6.5 provides a brief summary and conclusions.

6.1 Motivations

Three major factors motivated this study. Firstly, to examine the labour quality variable as it has policy implications for Chinese and Taiwanese governments. Secondly, to examine if there is strong evidence of structural change over time on the determinants of locational choices of TDI in China. Thirdly, to examine the FDI policy variable because it has policy implications for policy makers in China.

6.1.1 Labour Quality Variable

It has been argued that labour quality is an important determinant in the FDI flows into China. Chapter 6 noted that the Taiwanese government has been concerned about the high technological industries as a major power to balance in the threat from the Chinese government. The first purpose of this empirical study is to see whether the empirical specification I used, which is somewhat different from the one used by Cheng and Kwan (2000a, 2000b) and Gao (2004), yields any different qualitative results on labour quality from the aggregate data. Empirical results in both studies by Cheng and Kwan (2000a, 2000b) show no significant FDI effect on labour quality. However, a recent study by Gao (2004) using recent data on Chinese provincial-level FDI by investing country shows that labour quality plays a significant and positive role in attracting FDI.

Cheng and Kwan (2000a) examine the determinants of the location choices of FDI in China. Among those considered are regional market size, labour costs, FDI policy, infrastructure, and labour quality. An empirical specification is derived from a partial adjustment the FDI model which is then applied to data on FDI stocks by province over the period of 1983-1995. The empirical results from Cheng and Kwan (2002a) show significant and positive effects on the regional market size, transportation, and FDI policy. But labour quality, as proxied by various measures of educational attainment of a province's total population, is found insignificant in explaining the regional distribution of FDI (Cheng and Kwan, 2000a; Gao, 2004).

A further investigation into the matter by Cheng and Kwan (2000b), using the same empirical model but a different set of measures of labour quality, including such elements as the number of teachers and staff in institutions of higher education, and the number of teachers and staff in institutions of secondary education, again fails to show any significant effect on labour quality (Cheng and Kwan, 2000b; Gao, 2004).

A similar study by Gao (2004) used recent data on Chinese provincial-level FDI by investing country and found that labour quality plays a significant and positive role in

attracting FDI. Gao's (2004) study is in contrast to the empirical results in Cheng and Kwan (2000a, 2000b), one which show no significant FDI effect on labour quality. The purpose of this chapter is therefore to examine whether my own empirical specification, which is somewhat different from the one used by Gao (2004) or Cheng and Kwan (2000a), yields any different qualitative results on labour quality from the data.

The issue concerning the relationship between FDI location and labour quality has implications about the nature of FDI in China (Gao, 2004). It therefore also has policy implications about the nature of TDI in China for policy makers.

It is quite obvious that China is abundant in unskilled labour, and that the low costs of labour are one of the many location advantages China possesses as far as FDI is concerned. However, China views FDI as an important vehicle for technology transfer. Therefore, it has explicitly encouraged FDI with high technology or sophisticated products, and expects that FDI can bring advanced technology and management to local firms (Gao, 2004). If the insignificance of labour quality on TDI location is indicative of the low technology intensity of TDI, the extent of the technology transfer through TDI in China may be limited. On the other hand, the Taiwanese government has long prevented large direct investment projects on the Mainland, and has denied any transactions entailing high technology transfer (Charles and Pollack, 2002). The fact is that the Taiwanese government has been concerned about the technology transfer from Taiwanese firms based in China into Chinese firms, which may impact on the Taiwanese economy. Therefore, the Taiwanese government has limited the TDI flows into China. The beneficial effects of TDI on the Chinese technology growth are limited if TDI only works with unskilled workers in China. As a result, it is an important motive for this study to explore and ask whether labour quality is an important determinant in locational choices of TDI in China.

6.1.2 An Examination of Structural Change

Hou and Zhang (2001) divided the full sample of TDI in China into three sub-samples: over the periods 1987-90, 1991-94 and 1995-2001. Hou and Zhang's study (2001), found that there is strong evidence of structural change over time for determinants of TDI from 1987 to 2001. Hou and Zhang (2001) suggest that a simple aggregation of the time series into one single stage will lose much insight as the supply and demand factors of the TDI location choices have changed at many levels. Not only will the significance of the levels of the coefficients decline, they may even lead to dubious conclusions.

There were a few major events in 2001 and 2002 in cross-Strait economy including i) China entering the WTO at the end of 2001; ii) Two direct shipping ports in Fujian being set up in 2001; iii) The Taiwanese government in 2002 relaxing its ban on investment in semiconductor facilities on the Mainland. Therefore, the data set is divided into two sub-periods of 1997-2001 and 2002-2003, which aims to examine if there is a structure change over time on the determinants of TDI in China.

6.1.3 An Examination of FDI Policy Variable

The last two decades have witnessed an extensive growth in Taiwanese direct investment flows to China. This has been accompanied by an increase in competition amongst local governments to attract TDI, resulting in a rise in investment incentives offered by the Chinese government and removal of restrictions on operations of foreign firms in special economic zones or other industrial zones. The Special Economic Zones (SEZs) are often said to have lost their competitive edge in attracting FDI as the policy of preferential tax treatment has spread throughout China (Fung et al., 2005). In this scenario, the question addressed by the study is: How effective are these selective government policies in attracting TDI flows to China? The study seeks to shed light on appropriate policies to pursue in order to encourage higher volumes of TDI and the likely implications for policy makers in China and Taiwan.

6.2 Hypotheses

The review of important theoretical reasoning in the previous chapters gives rise to the following eight research hypotheses linking locational choices of TDI determinants in China in my analysis.

Investment agglomeration refers to the concentration in some geographical areas of firms that are engaged in various aspects of a given business. Investment clusters form because the concentration of firms in a given location supports the development of specialized suppliers, allows labour market pooling, cuts down on transportation, and facilitates knowledge spillovers, all of which help to reduce costs (Chase et al., 2004). There is a strong positive self-reinforcing effect which TDI has on itself in term of the agglomeration effect. Once a region has attracted a significant mass of TDI, it will be easier for it to attract more TDI inflows, as new Taiwanese investors perceive the presence of other Taiwanese investors as a positive signal. Therefore, my first hypothesis is:

H1: The more TDI stock exists in a specific city/region, the more likely are Taiwanese investors to invest in that region.

Market size is considered to be one of the most important determinants of FDI. Market size is associated with the growth prospects of the host country market. A huge market size allows for the attainment of economies of scale, and transaction costs are thought to be lower in countries with higher levels of economic development (Caves, 1991; Zhao and Zhu, 2000; Erdal and Tatoglu, 2002). Therefore, firms usually invest in large markets to capitalize on firm-specific assets by entering the market first, or by following leading firms in the new market (Tahir and Larimo, 2003). A number of empirical studies on FDI have confirmed that the market potential has a significant and positive effect in attracting FDI at either national or regional level (e.g. Kawaguchi, 1994; Lim, 2001; Bevan and Estrin, 2000). A large market size provides a better opportunity for foreign investors to reduce entry costs and to attain economies of scale that make it conductive to sales not only in the international market, but also for re-export to other markets (Zhao and Zhu,

2000). I, therefore, expect that Taiwanese investors in China will locate their business operations in a region with a greater market potential. Hence I hypothesize:

H2: The number of TDI cases is positively related to the host region's market size.

According to the classical international division of labour theory, FDI is a vehicle for firms to maximize profits by locating their functions in different geographical areas. With this profit-maximizing objective, a firm would deploy its value-chain activities in a location that allows it to minimize costs (Zhao and Zhu, 2000). According to neoclassical theories, labour cost differentials are considered an important determinant of FDI (Tahir and Larimo, 2003). Since labour cost is a major component of cost, wage variables are frequently considered in the literature (Fung et al., 2003). Locational advantage induced by low wages increases the prospects of low production costs and could also stimulate firms to establish themselves with new products and in new markets as well. Low wage rates may create an opportunity to achieve plant-level scale and scope economies, higher production efficiency and a large market share (Tahir and Larimo, 2003). Labour cost, therefore, is an important determinant for TDI inflow into China as most Taiwanese firms are engaging in labour-intensive production activities. Hou and Zhang's (2001) research on TDI in China also shows that cross-province wage differentials have some impact on the location choices of TDI. Since labour costs vary widely within China, Taiwanese investors should prefer to locate their operations in areas with relatively lower labour costs. Hence my next hypothesis is

H3: There is a negative relationship between labour cost in a specific city/region and the TDI level in that city/region. The higher the labour cost, the fewer numbers of TDI cases

Porter (1990) explicitly discussed the important role of infrastructure in attracting foreign investments. A number of empirical studies (e.g. Broadman and Sun, 1997; Tseng and Zebreg 2002; Cheng and Kwan 2000a,b) have generally found that host country infrastructure plays a significant role in influencing the distribution of FDI. Therefore,

Taiwanese investors are also more likely to choose locations with better and more adequate infrastructure. Therefore, I propose:

H4: There exists a positive relationship between the infrastructure quality and the number of TDI cases in the city/region.

Human capital or education quality is an important determinant of FDI among developing countries (Noorbakhsh and Paloni, 2001), which is consistent with the fact that FDI has been becoming more knowledge- and skill-intensive in recent years (Gao, 2004). On the other hand, from the host economy's perspective, it is viewed as desirable to attract technology-intensive FDI. Many believe that the extent of technology transfer depends importantly on the technology intensity of FDI. To the extent that technology and human capital are complements, one indication of the technology intensity of FDI is the sensitivity of FDI location to skilled labour availability (Gao, 2004).

The education quality variable is included in the equation to capture the average level of human capital in each region (Fung et al., 2003). The hypothesis is that higher educated labourers will attract more TDI, especially increasing high-tech industries that have been investing in China. Therefore, I propose

H5: A region with a higher educational level will attract more TDI cases than other regions.

China's open door policy has been much more oriented to the coastal region. Export-oriented industries are heavily concentrated on the coast. All of the four SEZs and fourteen OCCs were established in the coastal areas, in which special favouable measurements were granted to attract FDI (Hou, 2002). As a result, FDI has been heavily concentrated in the coastal areas. Therefore, I propose

H6: Coastal region attracts more TDI cases than other regions.

Hofstede (1980, p23) describes culture as a "collective programming of mind that differentiate the motives and behavior of one social group to those of another". The unique feature of FDI in China is that the majority of China's inward investment has been contributed to by ethnic Chinese from Hong Kong, Macao and Taiwan (Wei and Liu, 2001). Culture and the ethnical relationship between China and Taiwan play an important part in business links between these two areas.

Taiwanese firms investing in China face a shorter culture difference, and would benefit from a lower cost in their efforts of integration. The increasing interest shown by Taiwanese investors in Fujian, situated along China's southeastern coast, is because of the common language and cultural backgrounds and the improving investment environment in the province. Fujian has always attached great importance to enhancing trade as well as cultural co-operation with Taiwan. Fujian faces Taiwan across the Straits, and historically has close ties with Taiwan. Fujian is a major hometown of overseas Chinese. Over the world, there are about 8 million overseas Chinese of Fujian origin and 80 per cent of Taiwan's population is of Fujian origin.

Both Taiwanese and Fujianese speak the same language, the Minnan dialect (Minnan *hua,* also known as *Hokkiewei; ujianhua*), and share similar culture backgrounds. Although the official language in Taiwan is Mandarin, most Taiwanese also speak the Minnan dialect. Taiwanese, just like other overseas Chinese, have a strong affection for their original home, and have a strong feeling of commitment to their family (Wei et al., 2004).

This cultural advantage, especially in linguistic and ethnic *guanxi*, substantially reduces contractual risk, and makes Taiwanese investors prefer to invest in the Fujian province. Therefore, I propose

H7: Cultural links lead Taiwanese investors to prefer investing in Fujian rather than other areas.

The locational choices of the investing firms can also be influenced by another market imperfection-the income tax rate (Tahir and Larimo, 2003). In China's FDI case, a major factor explaining the extent and speed of China's recent industrial development is the industrial park concept (Jürgens and Rehbehn, 2004) from Chinese government policies. A great number of empirical evidence suggest that a higher number of Special Economic Zones (SEZs) and other industrial sectors which implement preferential treatments, such as lower corporate rate, to foreign investors have great advantages over other regions in attracting FDI.

Therefore, the effects of policy incentives can be examined by including a number of the SEZs, OCCs and ETDZs. These areas are granted preferential tax and other policies can deal flexibly with foreign businesses (Fung, 2003). I, therefore, expect that Taiwanese firms would invest more in SEZs and other industrial sectors as they offer a low corporate tax rates and other preferential treatment to Taiwanese firms. Hence, I propose:

H8: TDI is lured to regions with a higher number of Special Economic Zones and other industrial sectors.

6.3 Data, Variable Measurement, and Econometric Model

Following the research hypotheses in the previous section, this section provides the data and limitation, variable measurement and model specification.

6.3.1 Data and Limitations

To test the hypotheses in this paper, I have used the provincial panel data which are compiled from various issues of the China Statistical Yearbook[31] issued by the State Statistics Bureau of the PRC (SSB) in China and the Statistics Monthly (*tongji yuebao*) issued by the Investment Commission, the Ministry of Economic Affairs (MOEA) in Taiwan. There are a number of methodological discrepancies between Chinese data and

[31] various issues; see also http://www.stats.gov.cn/tjsj/ndsj/

Taiwanese data but they are not thought to affect the nature of the main conclusions of the study.

I have employ eleven independent variables to operationalize the determinants of locational choices of Taiwanese direct investment in China. Measurements of location variables are discussed in section 6.3.2, and a summary of these variables is given in Table 6.1.

The following data on Chinese provinces are taken from the China Statistical Yearbook: GDP, population, road length, railway and waterways, education level, and the average wage (see Appendix 1 for details on data construction). In this study, the data for TDI cumulative stock will be used from 1991 due to data availability. Although Taiwan's entrepreneurs began investing in China in the late 1980s, Taiwan's Investment Commission did not compute formal statistics until 1991 (Tung, 2000).

In my sample, a region is a province, a centrally administered municipality or automous region. However, not all provinces publish their inward FDI flows by major investing country, and for those that do, many of them started providing these data only recently. Due to data availability, there are 19 provinces or regions in China included. For example, Tibet is excluded because of a lack of complete data.

Largely due to the incompleteness of some data, the modeling exercise is confined to the period of 1997-2003. For example, there is a missing observation for Chongqing's FDI in 1996. The data set for GDP, education level, infrastructure, labour costs, and agglomeration is put together to cover 19 major Chinese regions. They are unbalanced due to missing observations. Beginning from 1997, the China Statistical Yearbook publishes information on the composition of employed persons by education level and province. This information is thus available for 1997 to 2003. I believe that it is the most direct information on labour quality by province.

There are three limitations on the TDI data. First, there is a Taiwanese ban on direct investment in China. Therefore, some of the TDI in China has been channeled from a third area, such as Hong Kong. There is no statistical information for the round-tripping of TDI. I interviewed some senior officers in the Mainland Affairs Council in May 2005 in Taipei about the data availability of TDI in China. Because the Taiwanese government still discouraged TDI flow into China, the Taiwanese government only published limited statistical data. The Taiwanese government thinks more statistical investment data may encourage more TDI into China. Therefore, many Taiwanese firms choose not to report their Mainland investment to the Taiwanese government to avoid bureaucratic procedures and political intervention in their Mainland investment.

Second, statistics from MOEA do not include the overseas subsidiaries' investment from large firms into China. As the Taiwanese government still restricts the amount and types of the investment projects in which Taiwanese firms can engage in China (Siu et al., 2003), some large Taiwanese firms have set up overseas subsidiaries to avoid dealing with the Taiwanese government in terms of indirect investment into China. Therefore, the investment types from Taiwan to China are either direct or indirect. Indirect investment in China was not officially recognized until 1990, though such activity dated back to 1983. In reality, Taiwanese firms choose to channel through a third area, mainly Hong Kong, in order to comply with the restraints on "China's investment" from the Taiwanese government. Therefore, there are also statistical biases in measuring TDI into China.

Third, statistical figures from the Taiwanese government include lagged reports and approvals from 1993, 1997 and 1998. The figures in those three years do not represent the actual TDI figures. The volume of lagged reports and approvals in 1997 is much bigger than any other single year. There is a statistical bias on the data set if lagged reports and approvals are included. In this empirical study, I therefore use the statistical figures from the Taiwanese government, excluding lagged reports and approvals.

There are a number of limitations on Taiwanese data or Chinese data but they are not thought to affect the nature of the main conclusions of the study.

6.3.2 Variables Measurement

A great number of research papers have investigated the determinants of the locational choices of FDI in China; however, the literature for TDI in China has been quite limited. The variables used in this study's model have been identified as important factors in much of the existing literature.

The dependent variable is that of the location choices of TDI. Based on the previous literature review, this thesis has identified a variety of such variables. My choice of explanatory variables is governed by data availability and theoretical issues. The explanatory variables used in this study including, statistics on investor and host country characteristics (agglomeration, market size, labour cost, infrastructure, education level, coast location, culture difference and FDI policy), are defined below. The definitions and expected impact of explanatory variables are listed in Table 6.1.

(1) Agglomeration

The cumulative TDI stock of each region is used in measuring the agglomeration variable. Cheng and Kwan (2000a, 2000b) found a strong positive self-reinforcing effect of FDI on itself, which is consistent with the agglomeration effect identified by Head and Rises (1996). As previous studies have generally found the subcontracting system has been playing an important role in Taiwan's economy and caused agglomeration effects. I have also used 'cumulative TDI stock' to measure the agglomeration effect of TDI flows into China. The sign of the coefficient is expected to be positive for both sub-periods.

(2) Market Size (GDP)

Some empirical studies have used GDP or GDP per capita to measure host country market size (e.g. Wei and Liu, 2001; Erdal and Tatoglu, 2002; Zhang et al., 2004). The importance of the market size has been confirmed in many previous empirical studies. For foreign investors, the size of the host market, which represents the host country's economic conditions and the potential demand for their output, should be an important element in their FDI decision-makings (Fung et al., 2005).

Fung et al. (2005) used gross domestic product (GDP) to measure the importance of size on the local market. In my model, the GDP of each region is also used to examine the importance of size on the local market. Economic growth may create large local markets and business opportunities for FDI inflows. The major motives for TDI in China are market-seeking and resources-seeking FDI. The motive for the Taiwanese starting to invest in China is to take advantage of the low labour costs and then to export in terms of resource-seeking FDI. However, the motive has gradually been changing to that of selling in China after China joined the WTO in terms of market-seeking FDI. Market-seeking FDI aims to set up enterprises to supply goods and services to the local market. The resource-seeking FDI mainly looks for cost competitiveness. There are also some factors in common for both types of FDI. China is thought to have all these characteristics. Even for resource-seeking FDI, the market size is important because larger economies can provide larger economies of scale and spill-over effects (OECD, 2000). Since this variable is used as an indicator of the market potential for the products of Taiwanese investors, the sign of the coefficient is expected to be positive for both sub-periods.

(3) Labour Cost (LABCOS)

Since labour cost is a major component of total production cost, wage variables are frequently considered in the literature (Fung et al., 2005). Average wages per labour vary from province to province and city to city in China (Zhao and Zhu, 2000). A high nominal wage, other things being equal, deters inward FDI, particularly for those firms that engage in labour-intensive production activities (Fung et al., 2003; Fung et al., 2005). Hou and Zhang (2001) used the average annual real wage of manufacturing workers in a province to measure the labour cost variable of locational choices for Taiwanese manufacturing branch-plants in China. In my study, the average annual real wage of workers in a region will be used to measure labour cost variables across regions. However, to avoid the potential simultaneity bias between investment and wages, my study uses the average wage lagged one period. The sign of the coefficient is expected to be negative for both sub-periods.

(4) Infrastructure (INFRA)

Infrastructure (INFRA) refers to the physical structure in the host country. Some empirical studies (e.g. Coughlin and Segev, 2000; Hou and Zhang, 2001) use the paved road adjusted for region size as a proxy for infrastructure variable. A recent study by Fung et al. (2003) used four variables in terms of length of railway, inland waterway, high quality roadway and medium quality roadway, to measure the infrastructure variable. In my empirical study, INFRA is the total length of highways, inland waterway and railways in a region, divided by its area. The sign of the coefficient is expected to be positive for both sub-periods.

(5) Education Level (EDU)

Similar to Fung's study, the variable EDU is included in the equation to capture the average level of human capital or labour-quality in each region (Fung et al., 2005). It has been argued that the education level impacts on the locational choices of FDI in China. Cheng and Kwan (2000a, 2000b) found none of the education variables serving as proxies for labour quality as having a significant impact on FDI. However, Hou (1996, 2001) suggests that this is typically a proxy for human capital and can prove to be a very important source of growth for Taiwan, and hence naturally expected to be something that TDI seeks also.

As mentioned in the previous section, labour quality can be regarded as an important variable for the Taiwanese government's Mainland investment policy. In this study, I have construct three labour quality measures corresponding to different levels of education. To experiment with an appropriate choice of the labour quality variables, I tried three alternative proxies. They are (a) the percentage of population with at least junior secondary school education (EDU1); (b) the percentage of population with at least senior secondary school education (EDU2); and (c) the percentage of population with at least college and higher education (EDU3).

A comparison with Cheng and Kwan's (2000a) labour quality measures can be made. They constructed this based on information on the education level of the entire population by province and available from the China Statistical Yearbook: the percentages of the population aged 6 and over with at least primary school education, junior secondary school education and senior secondary school education. Slightly different from Cheng and Kwan's study, my study will examine another labour quality variable, college and higher education, instead of primary school education, because it is felt that high quality labour tends to plays an important role in TDI in China, especially in high-tech industries which have gradually been moving to China in recent years.

By doing so, it aims to examine if technology transfer from TDI into China is significant. The sign of the coefficient for EDU1 is expected to be negative for both sub-periods. The sign of the coefficient for EDU2 is expected to be positive before 2002 but negative after 2001. The sign of the coefficient for EDU3 is expected to be positive for both sub-periods.

(6) Investment Location (COAST)

This thesis includes two dummy variables. The first dummy variable is COAST. It is used to differentiate among provinces that lie on the coast and those that do not. Coughlin and Segev (2002) suggest that the role of this variable is to control for the influence of determinants the authors have not explicitly included, that may differ systematically between coastal and non-coastal provinces. In the case of China, the coastal areas can be identified as the low information cost location (Wei and Liu, 2001), and therefore can be assumed to have a good investment environment (Wei et al., 2004). The inland locations, however, are often perceived as having a lower degree of economic liberalisation, poor infrastructure and low efficiency (Wei et al. 2004). My thesis adopts a similar approach in examining this dummy variable. This dummy variable, COAST, takes the value of one for the coastal areas, and zero otherwise (See Appendix 5). The sign of the coefficient for COAST is expected to be positive for both sub-periods.

(7) Culture Links (CULTU)

Another dummy variable in my thesis is the culture link (CULTU). Wei et al. (2004) suggests that it would be ideal to assign individual numeric values of cultural distance to foreign invested firms from different countries/regions as the data set of Hong Kong, Taiwan, Macao and Taiwan can be differentiated from other FDI because of a cultural difference. In Hou and Zhang's study (2001), cultural links are a dummy for the Fujian province that is not only geographically adjacent to Taiwan, but also speaks the same dialect (Minnan dialect). Most Taiwanese came from the Fujian province. This dummy variable, CULTU, takes the value of one for the Fujian province, and zero otherwise. The sign of the coefficient for CULTU is expected to be positive for both sub-periods.

(8) FDI Policy

Industrial zones have been the beneficiaries of preferential policies from the central government. Existing industries zone include a number of Special Economic Zones (SEZs), Open Coastal Cities (OCCs), Economic and Technological Development Zones (ETDZs), Bonded Zones, New and Hi-tech Development Zones, Export Processing Zones, the Taiwanese Investment Zone, and Border Economic Cooperation Zones (Mainland Affairs Council, Taiwan, 1998; Cheng and Kwan, 2000b; Fung et al., 2002; Fung et al., 2005).

Similar to Cheng and Kwan's (2000a) and Gao's (2004) studies, two FDI-policy variables are constructed for my study in terms of SEZS and ZONES.

SEZS, the first FDI policy variable, is the number of SEZs in a region. Although there are only a total of five SEZs located in three provinces (Guangdong, Fujian, and Hainan), they played a large role in promoting FDI in China in the early years of economic reforms, and have had lasting effects. The first policy variable (SEZS) is time invariant over the sample period. I leave Special Economic Zones as a separate explanatory variable (SEZS).

The other variable labeled "ZONES" is the number of OCCs and ETDZs. Similar to Gao's (2004) study, ZONES are treated separately from SEZS because they were approved, and proliferated, later (especially the ETDZs), and therefore are likely to have different effects on FDI (Gao, 2004). To a large extent, the ETDZs were an extension of the OCCs. In contract with these policy designations, the SEZs were introduced earlier. In terms of the benefits provided by these policy designations, the SEZs were clearly at the top, to be followed by the OCCs and the ETDZs, while the other Zones would be at the bottom (Cheng and Kwan, 2000a). Given the positive and significant correlation of the policy variables of the OCCs and ETDZs, I enter their sum as an aggregate policy variable (called ZONES) in my empirical study.

There are a total of fourteen OCCs, all approved in 1984. By 2005, there were fifty-four state-level ETDZs[32], among which were 34 Eastern Coastal regions, and 21 Middle West regions. By 2000, there were forty-one state-level ETDZs. Among those, thirty-two were approved by the central government prior to 1997, the starting year of my sample, and the rest in 2000 to 2002 (Chen; 2000; Gao, 2004). Therefore, ZONES is not a time invariant over the sample period.

The Taiwanese official statistics only cover 19 regions in China. Due to the data availability for Taiwanese investment location in China, 47 ETDZs were used for this study. A detailed explanation for the designation of each policy is given in Appendix 2, 3 and 4. The expected signs for both policy variables are positive.

Table 6.1 Definitions and Expected Impacts of Explanatory Variables

Variable	Definitions	Expected impacts (1997-2001)	Expected impacts (2001-2003)
$TDISTOCK_{j,t}$	Cumulative TDI stock of region j at time t.	+	+
$GDP_{j,t}$	GDP of region j at time t .	+	+

[32] See http://www.china.org.cn/english/SPORT-c/76751.htm

$LABCOS_{j,(t-1)}$	Average annual wage of region j at time t-1.	-	-
$INFRA_{j,t}$	Kilometers of highways, inland waterway and railways in region j per square kilometers of land mass at time t.	+	+
$EDU1_{j,t}$	The ratio of number of students enrolled in junior high schools in region j to its population at time t.	-	-
$EDU2_{j,t}$	The ratio of number of students enrolled in senior high schools in region j to its population at time t.	+	-
$EDU3_{j,t}$	the ratio of the number of students enrolled in college and higher education in region j to its population at time t.	+	+
CULTU	A dummy variable. Take the value of one for Fujian province, and zero otherwise.	+	+
COAST	A dummy variable. The region lies on the coast or not. Takes the value of one for the coastal areas, and zero otherwise.	+	+
$SEZS_{j,t}$	The number of Special Economic Zones in region j at time t.	+	+
$ZONES_{j,t}$	The number of Open Coastal Cities and Economic and Technological Development Zones in region j at time t.	+	+

Note: The signs (+ or -) in parentheses indicate expected effects on the location choice of TDI.

6.3.3 Model Specification

To model where branch-plants are likely to open, one begins with the assumption that Taiwanese firms rationally evaluate all relevant characteristics from a set of alternative locations in order to seek the highest expected profits. Therefore, a Taiwanese firm will choose to invest in a particular region only if doing so will maximize its profit (Hou and Zhang, 2001).

Because of the nature of the dependent variables and the information set describing the attributes of alternative sites, the conditional logit model[33] (CLM) by McFadden (1974) is adopted to estimate location probabilities. Hou and Zhang (2001) also adopted the CLM to examine the determinants on locational choices of Taiwanese manufacturing branch-plants in Mainland China. The conditional logit has many applications in economics, marketing, transportation research, and other fields. Some of the popular examples in the literature analyze selecting mode of transportation, occupational choice, or choice among competing products, to name just a few (Tabakova, 2005).

The profit (π_{ij}) that the i^{th} Taiwanese firm derives from location in the j^{th} region may be written as a function of the characteristics of that location and a distribution term, that is:

$$\pi_{ij} = \boldsymbol{C} + \mathbf{X}_j \beta + \varepsilon_{ij}$$

where $\boldsymbol{C}$ is the constant term, $\mathbf{X}_j$ is a vector of observable characteristics for j^{th} region, the term β is a vector of estimated coefficients, and ε_{ij} is a random disturbance term reflecting specification errors.

The probability of selecting a specific region depends on the attributes of the selected region relative to attributes of all other regions which are in the choice set. If the random disturbance term ε_{ij} has an independent and Weibull distribution, the Conditional Logit Model can be expressed as:

$$P_j = \frac{\exp[\mathbf{X}_j \beta]}{\sum_{k=1}^{K} \exp[\mathbf{X}_k \beta]}$$

[33] This model was done by Daniel McFadden (1974), who was awarded a Nobel Prize for his work.

where P_j denotes the population relative frequency of locating in the j^{th} region. K is the number of alternative (regions). The maximum likelihood estimates of β may be obtained by maximizing the likelihood function.

$$L(\beta) = \prod_{j=1}^{K} P_j$$

According to the CLM, the probability of foreign investment in an area depends on the levels of its characteristics that affect profits relative to levels of these characteristics in other provinces. The dependent variable in the conditional logit model is the population relative to the frequency of cases of TDI in each region. The TDI-case population is defined as the total number of cases of TDI in a particular period.

6.4 Estimation Results

The Conditional Logit Model Regression Estimates for Taiwanese Direct Investment in China are presented in Table 6.2 for the two sub-periods of 1997-2001 and 2002-2003.

Table 6.2 Conditional Logit Model Regression Estimates (1997-2003)

Variable	Coefficient and t-ratios (1997-2001)	Coefficient and t-ratios (2002-2003)
TDISTOCK j,t	2.10229 (15.5) ***	0.57022 (13.662)***
GDPj,t	0.8966 (3.37)***	0.34429 (1.763)*
LABCOS j,(t-1)	0.11173 (4.58)***	0.01386 (0.643)
INFRAj,t	-0.56566 (-2.22)**	0.28372 (0.831)
EDU1j,t	-0.10471 (-7.85)***	-0.03733 (-2.821)***
EDU2j,t	0.00324 (0.33)	0.00628 (0.294)
EDU3j,t	0.1063 (7.8)***	0.09527 (3.851)***
CULTU	0.80193 (7.51)***	1.85236 (16.827)***

COAST	0.10902 (0.8)	-0.16399 (-1.342)
SEZj,t	0.23174 (5.56)***	0.42115 (8.71)***
ZONESj,t	0.26036 (10.19)***	0.35033 (9.528)***
Likelihood Ratio test	8350	14405
Rsquare	0.109 (max possible= 0.267)	0.104 (max possible= 0.267)
Score (logrank) test	11692	18293
Wald test	4720	7217
Sample Size	72523	130739

Notes:

1. The Data set excludes lagged reports and approvals in 1997 and 1998

2. t-ratios are in parentheses.

3. ***, **, * indicate that the coefficient is significantly different from zero at the 1%, 5%, and 10% levels respectively.

Similar to Hou's study, my empirical one shows there is strong evidence of structure change over time. My study found that there is change on determinants of locational choices of TDI in China after China entered the WTO (the starting year of the second sub-period). China's entry into the WTO is considered as an important motivate for TDI in China because China had promised to open domestic markets, and therefore it was hoped to attract more TDI flows into China.

For the first sub-period (1997~2001), the empirical results show significant and positive effects of agglomeration (TDISTOCK), regional market size (GDP), labour cost (LABCOS), college and higher education (EDU3), culture distance (CULTU), and the FDI policy (both SEZS and ZONES) which were statistically significant at a level of 1 per cent. Junior high school education (EDU1) exhibits a negative relationship statistically significant at the 1 per cent level. However, COAST location and senior

secondary education (EDU2) are both found to be statistically insignificant. Infrastructure (INFRA) exhibits a negative relationship statistically significant at a level of 5 per cent.

For the second sub-period (2002~2003), the empirical results show a significant and positive effect for agglomeration (TDISTOCK), college and higher education (EDU3), culture distance (CULTU) and FDI policy (both SEZS and ZONES) which were statistically significant at a level of 1%. Junior high school education (EDU1) again exhibits a negative relationship statistically significant at a 1 per cent level. COAST location again is found to be statistically insignificant. Senior secondary education (EDU2) again is found to be statistically insignificant. Moreover, labour cost (LABCOS), infrastructure (INFRA), and senior secondary education (EDU2) are also found to be statistically insignificant.

(1) Agglomeration (TDISTOCK)

The coefficient for agglomeration (TDISTOCK) for both sub-periods is positive and statistically significant at a level of 1%, confirming the hypothesis that TDI inflows are positively related to the agglomeration effects. This is in line with the existing literature which found a strong positive self-reinforcing effect of FDI on itself, which is consistent with the agglomeration effect identified by Head and Rises (1996) and Cheng and Kwan (2000a, b).

(2) Market Size (GDP)

In line with existing studies, the coefficient for market size (GDP) for both sub-periods (1997~2001) is positive and statistically significant at a level of 1% and 10% respectively, confirming the hypothesis that the TDI inflows are positively related to the host region's market size.

(3) Infrastructure (INFRA)

Agglomeration effects are most commonly proxied by the quality of infrastructure, degree of development, and lagged stock of FDI (Demekas, 2005). Empirical results show that cumulative TDI STOCK for both sub-periods are positive and statistically significant at a level of 1%. Surprisingly, infrastructure (INFRA) exhibits a negative relationship and is statistically significant for first sub-period (1997~2001) at a level of 5 per cent but statically insignificant for the second sub-period (2002~2003).

This implies that agglomeration effects are mostly from cumulative TDI stock itself such as the subcontracting system, and not from the infrastructure. Moreover, in line with a recent study from Fung et al. (2005), it was found that empirically soft infrastructure consistently outperforms hard infrastructure as a determinant of FDI.

(4) Investment Location (COAST)

Surprisingly, COAST is found to be statistically insignificant for both sub-periods. Although the COAST location variable has been regarded as an important role in promoting FDI in China by the existing literature compared with the FDI policy variable, the FDI policy variable plays a more significant role in TDI locational choices in China. The result of the COAST variable highlights one somewhat neglected aspect of the TDI's location choices. It implies that the actual determinant behind the COAST location are the FDI POLICY motives on those coast cities instead of the COAST location itself.

(5) Labour Cost (LABCOS)

The coefficient for labour cost for 1997~2001 is positive and statistically significant at a level of 5%. For the sub-period (2002~2003), labour cost is found to be statistically insignificant.

This is in contrast to the empirical results in Cheng and Kwan (2000a, 2000b), which show that low wage costs have been an especially important factor in attracting exported-

oriented FDI from Hong Kong and Taiwan as a response to rising wage costs in their own and other economies in the region.

In line with a recent study by Zhang (2003), the decision on where to invest in China is based more on cultural background and specific incentives offered by local governments rather than comparative wage rates within China.

To some extent, labour quality and labour cost are both involved in a trade off relationship. In line with Hou's study which shows that labour cost plays no role after 1995, as with the more technology-intensive production, labour cost became relatively less important, while the quality of labour would become a significant determination factor (Hou, 2002).

(6) Labour Quality (EDU1, EDU2 and EDU3)

College and higher education (EDU3) is statistically significant at a level of 1 per cent for both sub-periods. Junior high school education (EDU1) exhibits a negative relationship statistically significant at a level of 1 per cent for both sub-periods. Senior secondary education (EDU2) exhibits statistically insignificant figures for both sub-periods. This is line with the empirical results in Siu et al. (2003), which shows strong evidence of a positive effect of labour quality for TDI locational choices in China. However, this is in contrast to the empirical results in Cheng and Kwan (2000a, 2000b), which show no significant FDI effect on labour quality.

China views FDI as an important vehicle for technology transfer. Therefore, it has explicitly encouraged FDI with high technology or sophisticated products, and expected that FDI can bring advanced technology and management to local firms (Gao, 2004). By examining the quality variable, the results found that college and higher education (EDU3) exhibits a positive relationship statistically significant at a level of 1 per cent for both sub-periods. The beneficial effects of TDI on the Chinese technology growth would be significant when TDI gradually works with skilled workers in China. This implies that

the extent of high technology intensity of TDI in China, and the extent of technology transfer through TDI in China, may be significant.

This empirical result for labour quality is also in line with the current Taiwanese sectoral distribution. Tung (2004) suggests that in the late 1980s and early 1990s, most of Taiwan's investment in China was in the shoe, textile, apparel and plastics industries. By the mid-1990s, the bulk of Taiwan's investment in China was concentrated in electronic and electric appliances and basic metals industries. Since the mid-1990s, Taiwanese firms in China have expanded from labour-intensive manufacturing investment to more capital and technology-intensive ventures, particularly in the IT industry. Other major industries, such as IC related industries and LCD industries, have gradually been investing in China. Chase et al. (2004) assert that after more than a year of acrimonious political debate and extensive lobbying efforts by the major Taiwanese semiconductor companies, including industry leaders, Taiwan Semiconductor Manufacturing Corporation (TSMC) and United Microelectronics Corporation (UMC), the Taiwanese government early in 2002 relaxed its ban on investment in semiconductor facilities on the Mainland. The EDU3 variable, therefore, may have policy implications for the Taiwanese government on measuring technology competitive advantages.

In summary, because the TDI's sectoral distribution has gradually changed from labour-intensive industries to more capital, and technology-intensive industries, the variables of labour quality have changed over time.

(7) Cultural Links (CULTU)

Among all the variables, cultural links (CULTU) are one of the most important determinants in TDI locational choices in China for both the sub-periods. Table 6.2 indicates that a one-percent increase in CULTU is associated with a 0.80 percentage increase in the number of TDI cases in the first sub-period (1997~2001) and a 1.85 percentage increase in the number of TDI cases in the second sub-period (2002~2003). This also explains why the importance of the CULTL variable between Fujian and

Taiwan is magnified for the second sub-period (2002~2003), especially as the new FDI policy in 2002 opened two direct shipping routes from Fujian to Taiwan.

At the end of 2001, China and Taiwan joined the World Trade Organisation (WTO). For China, one of the great milestones for economic development and reform in China, and for the world trading system, was the accession of China to the World Trade Organization in November 2001. Following the WTO entry, China attracted a record of US$52.7 billion in total foreign direct investment in 2002 (People's Daily, 2003). The WTO entry is also expected to increase the exports on both sides of the Taiwan Straits. China's WTO entry, along with the increased purchasing power of the general population, has contributed to a dramatic rise in TDI in most areas in China. However, in 2002, Fujian was one of the largest recipients of TDI among all the regions in China. The number of new investment cases in Fujian surpassed all other regions in 2002, although the average TDI in Fujian is smaller than that in Jiangsu. The statistical data shows that number of cases increased more than 10 times in 2002 compared with 2001. Reviewing the major events in 2001 between China and Taiwan, with the two direct shipping routes of Xiamen-Jingmen and Mawei-Mazu opening in 2001[34], Fujian started trying to develop trade co-operation with SMEs in Taiwan. This explains why the number of cases has increased sharply in Fujian since 2002. To take advantage of the cultural links, the two direct shipping ports are located in Fujian. The t-ratio for culture links (CULTU) got larger compared with the two sub-periods. This implies that cultural links have kept playing an important role in TDI's locational choices in China. This result also has policy implications for policy makers in China and Taiwan.

(8) FDI POLICY (SEZS and ZONES)

The effect of SEZS and ZONES are positive for TDI for both sub-periods. Out of the two types of FDI policy variables, ZONES appears to be the most influential for TDI. The results support the hypothesis that regions designated with SEZ, ETDZ and OCC confer advantages to these regions. By implementing tax and other policies favorable to foreign

[34] See China Daily, May 17, 2005.

investors, SEZs, ETDZs, OCCs lower tax burdens on the foreign investors. They also signal an open economic environment where market reforms will continue to take place (Fung et al., 2002).

Similar to the empirical results from Fung et al. (2002), my study also shows SEZs still play an important role in FDI's locational choice. Existing literature (e.g. Head and Ries, 1996; Fung et al., 2002; Breslin, 2003; Zhou et al., 2002) acknowledges that there is considerable competition from the various zones to attract investment. SEZs are often said to have lost their competitive edge in attracting FDI as the policy of preferential tax treatment has spread throughout China (from the south to the north and from the coastal areas to the interior)(Fung et al., 2002), however my study shows unambiguously the significant positive effect of those areas is in the case of attracting TDI.

By reviewing the econometric results, the Chinese government has choosen a broader approach that focuses on improving their domestic infrastructure, cultural links, so that the FDI policy meets the demands and expectations of Taiwanese investors.

6.5 Conclusion

Understanding the determinants of the location of MNE affiliates has become increasingly important for policy makers at the local, regional, national, and supra-national level, as investment promotion schemes are increasingly seen as an important cornerstone in the industrial development of most countries and regions (Hogenbirk & Narula, 2004).

This paper has examined the locational choices of Taiwanese direct investment in China using a regional data set from 1997 to 2003. Similar to Hou and Zhang's study (2001), I have divided the full sample into two sub-samples, 1997-2001 and 2002-2003, and find that there is strong evidence of structural change over time.

Most interestingly, college and higher education (EDU3) labour quality keeps playing a significant and positive role in attracting TDI from Taiwan. This empirical study is in line with the sectoral distribution in TDI in China. These econometric estimates can be understood in the light of the stylized facts of Taiwanese direct investments in China.

Market size (GDP), agglomeration (TDISTOCK), college and higher education (EDU3), cultural links (CULTU), FDI policy variables (SEZS and ZONES) are all found to have significant influence on TDI's locational choices. However, the infrastructure (INFRA), investment location (COAST), labour cost (LABCOS) variables appear to be less promising determinants in the analyses. The estimated coefficient for infrastructure variable (INFRA) is negative for the first sub-period but insignificant for the second sub-period. The coefficient for labour cost variable (LABCOS) for the first sub-period is positive and statistically significant but for the second sub-period is found to be statistically insignificant. Investment location variable (COAST) is found to be statistically insignificant for both sub-periods.

Cultural links keep playing an important role for TDI locational choices in China, especially as Fujian is located in a coastal area and China's FDI policy gives support for direct shipment. This result implies that FDI policy can link with cultural ties successfully, which shows a positive message to the Chinese government.

My large sample evidence suggests that the determinants of regional distribution on TDI have changed over time. Overall, the empirical results suggest that regional distribution of TDI seems to have been determined largely by agglomeration effects, FDI incentive policy, education level, cultural background and specific incentives offered by local governments rather than comparative wages rate or the quality of the infrastructure.

The empirical analysis in this chapter has attempted to examine the determinants of the locational choices on TDI in China for the period, 1996 to 2003, based on a conditional logit model framework. By dividing the time series into two stages, I have clearly demonstrated a structural change has happened in the locational choices of TDI in China.

The findings of the study are amazingly consistent both with economic theory and the existing economic literature.

Chapter 7 Conclusion

7.1 Concluding Remarks

Despite periodic political tensions between the two sides of the Taiwan Strait, Taiwanese direct investment (TDI) in Mainland China has grown very rapidly in the past few years. The Taiwanese government efforts to curb and regulate this trend have been belated and only partially successful. Considering that within that last decade nearly half of Taiwan's overseas investments have been in China, it is interesting and important to explore the TDI in China.

Over the last two decades, Taiwanese firms have substantially extended their overseas production activities all over the world. Especially in the latter 1980s, periodic Taiwan currency appreciation played an important catalytic role and led to a massive expansion of such export-oriented FDI. The Taiwanese economy is still dominated by SMEs characterized by a heavy dependence on subcontracting relations. The fact that these SMEs were able to conduct FDI is due to their support by an efficient subcontracting production network encompassing a larger number of highly specialized producers. The subcontracting system therefore plays a key role in TDI. It can explain the unique motive for TDI from SMEs, which clearly distinguishes it from the FDI of oligopolistic enterprises analyzed by Stephen Hymer and Richard Caves, or the Japanese form of direct investment present by Kiyoshi Kojima. It is also an important determinant in Taiwanese direct investment at either national or regional level, which can be explained by the agglomeration theory.

TDI is widely disbursed across industries, but geographically concentrated in a few coastal areas in China. Under the subcontracting system, most of the TDI from hi-tech industries are regionally clustered in the Yangtze River Delta (i.e. Shanghai, Suzhou, Hangzhou, and Ningbo), while TDI from labour-intensive industries are clustered in two

southern provinces, Guangdong and Fujian, forming themselves into two distinct center-satellite networks.

Taiwan's FDI in China developed noticeably in the early 1990s. A more significant change was, from the middle 1990s, that larger and higher technology-intensive firms in Taiwan started to join forces in setting up subsidiaries in China. Many of these manufacturers receive orders in Taiwan, produce their goods in China, and then ship the goods from China directly to their overseas buyers, mostly to the USA and Japan (Lin, 1995; McLenahan, 2002; Huang et al., 2004). Compared with TDI in other parts of the world, the total TDI in China is large. However, the average size of TDI in Mainland China has been much smaller than that in Southeast Asia or the United States, ostensibly due to political uncertainty and restrictions in the size of individual investment projects (Chiu, 1995; Xie, 2002; Zhaoyong, Xu, & Zhang, 2003; Huang et al., 2004). Although politically embarrassing to the Taiwanese government, TDI provides an economic opportunity that is irresistibly attractive to business interests.

7.2 The Findings of the Thesis

TDI has been playing an important role in cross-Strait relationship, which is why this analysis was carried out. This thesis provides the pattern of TDI in Mainland China through identifying main characteristics of such capital flows; assesses main determinants that influence the pattern of investment across the Taiwan Strait. I therefore conducted an econometric analysis of the locational determinants of TDI in China based on a conditional logit model by utilizing the 1997 to 2003 survey data from either Chinese or Taiwanese official statistics. Several results have emerged from these econometric exercises, which have important policy implications for policy makers in both China and Taiwan.

Similar to Hou and Zhang's study (2001), these empirical results found that there was strong evidence of structural change over time for determinants such as, labour cost and infrastructure, and TDI in China at regional level. The factors behind the structural

change include China's WTO entry and the cultural links supported by the FDI policy. The results also show that the technology transfer from TDI into China has been significant for my sample period.

This empirical result for labour quality is also in line with the current Taiwanese sectoral distribution. Technological transfer from TDI into China tends to be significant as the determinant of labour quality variables play a significant role in TDI in China at regional level. The labour quality variable has important policy implications for the Taiwanese government in measuring technology competitive advantages.

Important locational determinants include agglomeration, market size, labour quality, FDI policy and cultural links. TDI responds to investment incentives from China's FDI policy. TDI also responds very positively to the tax and other incentives associated with SEZs, ETDZs and OCCs.

COAST is found to be statistically insignificant for both sub-periods. This result of the COAST variable highlights one somewhat neglected aspect of the TDI's location choices. It implies that the actual determinant behind the COAST location is FDI POLICY motives on these coastal cities instead of the COAST location itself.

7.3 Further Study

Based on the conditional logit model, this study provides empirical findings on the determinants of local choices of TDI in China. Research into FDI by Taiwanese firms in China is only at its beginning, and there are a large number of issues yet to be studied. There are many important and interesting topics open to further research in the area of TDI in China. This study, however, is not free from limitations and I would also like to provide recommendations for future research.

The unique characteristics of TDI in China described in this thesis have a number of implications for both research and policy considerations. Topics such as the importance

of ethnic *guanxi*-ties in inward/outward investment and the coexistence of political tension and economic interaction are worth further theoretical and empirical research (Yang, 1997). The growing TDI from Taiwan's SMEs in China highlights a different layer of capital needs on the Mainland, in local and also grass-root industries. All of these are areas which are also worth further theoretical and empirical research.

Ando and Kimura (2003) suggest that traditional statistical figures provide few clues for the mechanics of the subcontracting networks as international trade data just reveals what is traded between two countries, and does not indicate who is trading with whom. It is worth further study to explore the relationship between MNEs and Taiwanese subcontractors in China. Another interesting topic worth further study is that of just how the Taiwanese' subcontracting system has been transplanted into China.

This thesis has looked at the motivation behind TDI into China and suggests that the subcontracting system is a major motivation and determinants in TDI at both national and regional level. Different industries tend to have different agglomeration effects. This is another interesting topic worth further study.

The growing investments from Taiwan into China have significant political and economic influences on both sides of the Taiwan Straits. Topics such as how Taiwanese industrial migration into China impacts on the Taiwanese economy or political system is a most interesting topic, and one very much calling out for further research. There has been a sharp debate in Taiwan concerning the degree to which the TDI into China may have impacted on Taiwan's economy. There is a widespread view that China's success in attracting TDI has come at the expense of Taiwan's economy, and that China's future growth will necessarily limit Taiwan's economic prospects. It will therefore need to be considered whether TDI in China, and China's economic growth in regional contacts, has a positive or detrimental effect on Taiwan's economy, and the evidence for and against these oft-expressed views will need to be explored. .

Because the WTO accession agreement will open up domestic service sector industries that have previously been largely closed, particular in the areas of distribution, telecommunications, and financial services, it may impact on the characteristics of FDI in China. One of the interesting main issues is to compare the profile of TDI before and after China's entry into the WTO. It would therefore be helpful to re-examine the motivation and strategies of Taiwanese investors in the long run. This will also require further study.

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Appendices

Appendix 1 Data Sources

The Taiwanese Direct Investment data are taken from the *Statistics on Overseas Chinese & Foreign Investment, Outward Investment, Indirect Mainland Investment.* MOEA, Taiwan (various issues).

- Approved Taiwanese Direct Investment into China for 1991 to 2003

The following regional data for 1997 to 2003 are taken from the *China Statistical Yearbook* (various issues)

- GDP
- Regional populations
- Number of students enrolled in junior high school education
- Number of students enrolled in senior secondary education
- Number of students enrolled in college and higher education
- Length of waterways
- Distance of highways
- Distance of railway
- Average lagged wage

Appendix 2 Locations of Major Industrial Zones in China

Regions/ Provinces	SEZs (Special Economic Zones)	OCCs (Open Coastal Cities)	ETDZs (Economic and Technological Development Zones)
Guangdong	Shenzhen, Zhuhai and Shantou	Guangzhou and Zhanjiang	Guangzhou, Zhangjiang, Dayawan and Pnyu's Nansha
Fujian	Xiamen	Fuzhou	Fuzhou, Haicang and Dongshan
Guangxi		Beihai	Nanning
Hainan	Hainan		Hainan Yangpu
Shanghai		Shanghai	Jinqiao, Minhang, Pudong New Zone, Lujiazui, Hongqiao and Caohejin
Jiangsu		Lianyungang and Nantong	Nanjing, Wenzhou, Lianyunggang, Suzhou, Kunshan and Nantong
Zhejiang		Ningbo and Wenzhou	Hangzhou, Ningbo, Ningbo Daxiedao, Xiaoshan and Hangzhou
Hubei			Wuhan
Hunan			Changsha
Chongqing			Chongqing

Sichuan			Chengdu
Beijing			Beijing
Tianjin		Tianjin	Tianjin
Hebei		Qinhuangdao	Qinhuangdao
Henan			Zhengzhou
Shandong		Yantai and Quingdao	Yantai, Qingdao, Weihai and Taiyuan
Liaoning		Dalian	Dalian, Yingkou and Shenyang
Jilin			Changchun
Helongjiang			Harbin
Anhui			Wuhu and Hefei
Xijiang			Urumqi and Shihezi

Source: http://www.mofcom.gov.cn/

Appendix 3 FDI Policy Variable (for ETDZs)

Regions/Zones	ETDZs 1997	ETDZs 1998	ETDZs 1999	ETDZs 2000	ETDZs 2001	ETDZs 2002	ETDZs 2003
Guangdong	4	4	4	4	4	4	4
Fujian	3	3	3	3	3	3	3
Guangxi	0	0	0	0	1	1	1
Hainan	1	1	1	1	1	1	1
Shanghai	6	6	6	6	6	6	6
Jiangsu	6	6	6	6	6	6	6
Zhejiang	5	5	5	5	5	5	5
Hubei	0	0	0	1	1	1	1
Hunan	1	1	1	1	1	1	1
Chongqing	1	1	1	1	1	1	1
Sichuan	0	0	0	1	1	1	1
Beijing	1	1	1	1	1	1	1
Tianjin	1	1	1	1	1	1	1
Hebei	1	1	1	1	1	1	1
Henan	0	0	0	1	1	1	1
Shandong	3	3	3	3	4	4	4
Liaoning	3	3	3	3	3	3	3
Jilin	1	1	1	1	1	1	1
Helongjiang	1	1	1	1	1	1	1
Anhui	1	1	1	2	2	2	2
Xijiang	1	1	1	2	2	2	2

Source: http://www.mofcom.gov.cn/, caculated by the author.

Appendix 4 FDI Policy Variable (for OCCs and SEZs both time invariable)

Regions/Zones	SEZs	OCCs
Guangdong	3	2
Fujian	1	1
Guangxi	0	1
Hainan	1	0
Shanghai	0	1

Jiangsu	0	2
Zhejiang	0	2
Hubei	0	0
Hunan	0	0
Chongqing	0	0
Sichuan	0	0
Beijing	0	0
Tianjin	0	1
Hebei	0	1
Henan	0	0
Shandong	0	2
Liaoning	0	1
Jilin	0	0
Helongjiang	0	0
Anhui	0	0
Xijiang	0	0

Source: http://www.mofcom.gov.cn/, caculated by the author.

Appendix 5 Coast Variable (dummy variable)

Area	Coast
Guangdong	1
Fujian	1
Guangxi	1
Hainan	1
Shanghai	1
Jiangsu	1
Zhejiang	1
Hubei	0
Hunan	0
Chongqing	0
Sichuan	0
Beijing	1
Tianjin	1
Hebei	1
Henan	0
Shandong	1
Liaoning	1
Jilin	0
Heilongjiang	0

Appendix 6 Regional GDP (RMB: 100 million)

Regions	1996	1997	1998	1999	2000	2001	2002	2003
Beijing	1,615.73	1,810.09	2,011.31	2,174.46	2,478.76	2,845.65	3,212.71	3,663.1
Tianjin	1,102.40	1,235.28	1,336.38	1,450.06	1,639.36	1,840.1	2,051.16	2,447.66
Hebei	3,452.97	3,953.78	4,256.01	4,569.19	5,088.96	5,577.78	6,122.53	7,098.56
Shanxi	1,308.01	1,480.13	1,486.08	1,506.78	1,643.81	1,779.97	2,017.54	2,456.59
Inner Mongolia	984.78	1,099.77	1,192.29	1,268.2	1,401.01	1,545.79	1,734.31	2,150.41
Liaoning	3,157.69	3,582.46	3,881.73	4,171.69	4,669.06	5,033.08	5,458.22	6,002.54
Jilin	1,337.16	1,446.91	1,557.78	1,660.91	1,821.19	2,032.48	2,246.12	2,522.62
Heilongjiang	2,402.58	2,708.46	2,798.89	2,897.41	3,253	3,561	3,882.16	4,430
Shanghai	2,902.20	3,360.21	3,688.2	4,034.96	4,551.15	4,950.84	5,408.76	6,250.81
Jiangsu	6,004.21	6,680.34	7,199.95	7,697.816	8,582.728	9,511.91	10,631.75	12,460.83
Zhejiang	4,146.06	4,638.24	4,987.5	5,364.89	6,036.34	6,748.15	7,796	9,395
Anhui	2,339.25	2,669.95	2,805.45	2,908.583	3,038.236	3,290.13	3,569.1	3,972.38
Fujian	2,583.83	3,000.36	3,286.56	3,550.24	3,920.07	4,253.68	4,682.01	5,232.17
Jiangxi	1,517.26	1,715.18	1,851.98	1,853.65	2,003.07	2,175.68	2,450.48	2,830.46
Shandong	5,960.42	6,650.02	7,162.2	7,662.1	8,542.44	9,438.31	10,552.06	12,435.93
Henan	3,661.18	4,079.26	4,356.6	4,576.1	5,137.66	5,640.11	6,168.73	7,048.59
Hubei	2,970.20	3,450.24	3,704.21	3,857.99	4,276.32	4,662.28	4,975.63	5,401.71
Hunan	2,647.16	2,993.00	3,118.09	3,326.75	3,691.88	3,983	4,340.94	4,638.73
Guangdong	6,519.14	7,315.51	7,919.12	8,464.31	9,662.23	10,647.71	11,769.73	13,625.86
Guangxi	1,697.90	1,817.25	1,903.04	1,953.27	2,050.14	2,231.19	2,455.36	2,735.13
Hainan	389.53	409.86	438.92	471.23	518.48	545.96	604.13	670.93
Chongqing	1,179.09	1,350.10	1,429.26	1,479.71	1,589.34	1,749.77	1,971.3	2,250.56
Sichuan	2,985.15	3,320.11	3,580.26	3,711.61	4,010.25	4,421.76	4,875.12	5,456.32
Guizhou	713.70	792.98	841.88	911.86	993.53	1,084.9	1,185.04	1,356.11
Yunnan	1,491.62	1,644.23	1,793.9	1,855.74	1,955.09	2,074.71	2,232.32	2,465.29
Tibet	64.76	76.98	91.18	105.61	117.464	138.73	161.42	184.5
Shaanxi	1,175.38	1,300.03	1,381.53	1,487.61	1,660.92	1,844.27	2,035.96	2,398.58
Gansu	714.18	781.34	869.75	931.98	983.36	1,072.51	1,161.43	1,304.6
Qinghai	183.57	202.05	220.16	238.39	263.59	300.95	341.11	390.21
Ningxia	193.62	210.92	227.46	241.49	265.57	298.38	329.28	385.34
Xinjiang	912.15	1,050.14	1,116.67	1,168.55	1,364.36	1,485.48	1,598.28	1,877.61

Source: China Statistical Yearbook, various issues.

Appendix 7 Regional Populations (unit: 10,000 persons)

Regions	1997	1998	1999	2000	2001	2002	2003
National Total	123,626	124,810	12,5909	12,4261	127,627	128,453	1,260,498
Beijing	1,240	1246	1,257	1,356	1,383	1,423	14,070
Tianjin	953	957	959	984	1,004	1,007	9,956
Hebei	6,525	6569	6,614	6,668	6,699	6,735	66,569
Shanxi	3,141	3,172	3,204	3,247	3,272	3,294	32,558
Inner Mongolia	2,326	2,345	2,362	2,332	2,377	2,379	23,510
Liaoning	4,138	4,157	4,171	4,182	4,194	4,203	41,549
Jilin	2,628	2,644	2,658	2,680	2,691	2,699	26,684
Heilongjiang	3,751	3,773	3,792	3,623	3,811	3,813	37,693
Shanghai	1,457	1,464	1,474	1,640	1,614	1,625	16,061
Jiangsu	7,148	7,182	7,213	7,304	7,355	7,381	72,967
Zhejiang	4,435	4,456	4,475	4,593	4,613	4,647	45,934
Anhui	6,127	6,184	6,237	5,899	6,328	6,338	62,652
Fujian	3,282	3,299	3,316	3,409	3,440	3,466	34,261
Jiangxi	4,150	4,191	4,231	4,039	4,186	4,222	41,741
Shandong	8,785	8,838	8,883	8,997	9,041	9,082	89,775
Henan	9,243	9,315	9,387	9,123	9,555	9,613	95,029
Hubei	5,873	5,907	5,938	5,950	5,975	5988	59,184
Hunan	6,465	6,502	6,532	6,327	6,596	6,629	65,521
Guangdong	7,051	7,143	7,270	8,522	7,783	7859	77,676
Guangxi	4,633	4,675	4,713	4,385	4,788	4,822	47,661
Hainan	743	753	762	755	796	803	7,939
Chongqing	3,042	3,060	3,075	3,051	3,097	3,107	30,713
Sichuan	8,430	8,493	8,550	8,234	8,640	8,673	85,739
Guizhou	3,606	3,658	3,710	3,524	3,799	3,837	37,933
Yunnan	4,094	4,144	4,192	4,236	4,287	4,333	42,836
Tibet	248	252	256	261	263	267	2,638
Shaanxi	3,570	3,596	3,618	3,536	3,659	3,674	36,314
Gansu	2,494	2,519	2,543	2,512	2,575	2,593	25,628
Qinghai	496	503	510	482	523	529	5,225
Ningxia	530	538	543	548	563	572	5,650
Xinjiang	1,718	1,747	1,774	1,845	1,876	1,905	18,834

Source: The China Statistical Yearbook, various issues.

Appendix 8 Infrastructure 1997 (unit: kilometer)

Regions	Length of railways in operation	Extension length of the truck lines	Length of Navigable waterways	Total length of highways	Express way and class I to IV highways	Express way	First class	Second class	Highway below class IV
National	57,566	78,246	109,827	1,226,405	997,496	4,771	14,637	111,564	228,909
Beijing	1,069	1,733		12,306	11,842	144	244	1,040	464
Tianjin	526	928	90	4,287	4,204	101	383	862	83
Hebei	3,616	6,091	75	56,009	53,111	494	607	6,764	2,898
Shanxi	2,504	3,848	170	44,043	41,110	206	367	6,313	2,933
Inner Mongolia	5,078	6,041	802	49,992	42,351		18	1,759	7,641
Liaoning	3,569	4,972	508	44,041	43,148	509	557	6,544	893
Jilin	3,480	3,812	1271	33,075	31,388	243	201	2,260	1,687
Heilongjiang	4,948	6,595		49,631	48,956	147	345	3,135	675
Shanghai	244	396	2,100	3,961	3,952	64	241	593	9
Jiangsu	751	1,406	23,833	27,102	25,300	347	1,787	5,630	1,802
Zhejiang	942	1,419	10,592	36,127	30,888	168	414	3,266	5,239
Anhui	1,836	2,805	5,612	37,481	34,806	123	286	5,013	2,675
Fujian	1,068	1,080	3,725	47,680	38,190	94	289	3,669	9,490
Jiangxi	2,125	2,939	4,937	35,234	22,557	70	153	2,915	12,677
Shandong	2,351	3,665	1,414	59,260	58,912	354	2,035	14,723	348
Henan	2,355	4,456	1,104	55,015	52,231	416	78	7,333	2,784
Hubei	2,017	2,811	7,253	50,779	35,489		924	5,910	15,290
Hunan	2,293	3,194	10,050	59,761	31,674	45	207	2,646	28,087
Guangdong	782	1,455	10,808	91,862	79,430	785	4,053	10,299	12,432
Guangxi	1,973	2,225	4,521	45,378	30,283	193	189	1,670	15,095
Hainan	219	238	414	15,246	11,105	103	59	900	4,141
Chongqing	554	553	1,754	27,045	16,886		138	774	10,159
Sichuan	2,327	2,378	6,089	76,066	48,309	50	524	3,439	27,757
Guizhou	1,640	1,697	1,899	33,211	13,636		98	446	19,575
Yunnan	1,897	1,951	1,324	73,821	66,561	45	71	1,299	7,260
Tibet		2,302		22,455	10,525			568	11,930
Shaanxi	1,938	3,275	998	41,202	34,276	57	224	2,115	6,926
Gansu	2,322	1,098	219	35,594	25,112	13		2,657	10,482
Qinghai	1,095	787		17,640	13,485			1,236	4,155
Ningxia	712	2,098	395	9,048	8,426		107	1,320	622
Xinjiang	1,341			32,053	29,353		38	4,466	2,700

Source: The China Statistical Yearbook, 1998

Appendix 9 Infrastructure 1998 (unit: kilometer)

Regions	Length of railways in operation	Extension length of the truck lines	Length of Navigable waterways	Total length of highways	Express way and class I to IV highways	Express way	First class	Second class	Highway below class IV
National	57,584	78,940	110,263	1,278,474	1,069,243	8,733	15,277	125,245	209,231
Beijing	1,069	1,737		12,498	12,038	190	247	1083	460
Tianjin	527	959	90	4,335	4,252	182	341	965	83
Hebei	3,624	6,084	75	57,263	54,601	688	967	7,242	2,662
Shanxi	2,504	3,853	170	48,560	45,744	298	417	7,703	2,816
Inner Mongolia	5,077	6,148	952	58,430	52,867		18	2,096	5,563
Liaoning	3,558	4,981	508	44,483	43,716	707	619	7,136	767
Jilin	3,474	3,823	1,271	33,812	32,133	312	199	2,625	1,679
Heilongjiang	4,948	6,596		49,766	49,098	176	356	3,616	668
Shanghai	248	400	2,100	4,104	4,095	91	317	701	9
Jiangsu	757	1,440	23,908	27,331	25,610	401	1,942	6,138	1,721
Zhejiang	942	1,430	10,408	38,533	34,260	344	669	3,686	4,273
Anhui	1,836	2,805	6,002	39,264	36,851	294	152	5,548	2,413
Fujian	1,068	1,080	3,725	48,021	38,866	144	317	4,007	9,155
Jiangxi	2,125	3,047	4,937	36,867	24,589	212	15	3,255	12,278
Shandong	2,351	3,665	1,414	64,145	63,929	913	1,838	16,110	216
Henan	2,355	4,456	1,104	57,172	54,556	465	78	7,843	2,616
Hubei	2,028	2,941	7,256	52,989	38,537	428	502	6,580	14,452
Hunan	2,299	3,244	10,050	60,071	32,241	166	191	3,353	27,830
Guangdong	774	1,456	10,808	92,713	82,786	810	4,766	10,927	9,927
Guangxi	2,014	2,364	4,521	51,073	43,319	439	389	2,107	7,754
Hainan	219	222	414	16,920	12,779	302	59	784	4,141
Chongqing	591	591	1,754	27,210	17,516	157	16	1,080	9,694
Sichuan	2,289	2,408	6,089	81,646	56,377	328	501	5,522	25,269
Guizhou	1,648	1,711	1,899	33,604	14,137	86	32	505	19,467
Yunnan	1,855	1,933	1,324	76,957	69,783	205	61	1,311	7,174
Tibet				22,455	10,525			568	11,930
Shaanxi	1,941	2,303	998	42,202	35,316	212	120	2,469	6,886
Gansu	2,322	3,279	219	35,865	25,518	13		2,714	10,347
Qinghai	1,092	1,098		17,936	14,024			1,306	3,912
Ningxia	712	789	397	9,487	8,876		107	1,342	611
Xinjiang	1,341	2,098		32,762	30,304	170	41	4,923	2,458

Source: The China Statistical Yearbook, 1999

Appendix 10 Infrastructure 1999 (unit: kilometer)

Regions	Length of railways in operation	Extension length of the truck lines	Length of Navigable waterways	Total length of highways	Express way and class I to IV highways	Express way	First class	Second class	Highway below class IV
National	57,922.5	80,510.9	116,504	1,351,691	1,156,736	11,605	17,716	139,957	194,955
Beijing	1,141.1	1,815.4		12,825	12,370	230	296	1177	455
Tianjin	529.6	958.3	443	8,844	8,761	231	369	1194	83
Hebei	3,619.4	6,049.7	75	58,162	55,648	1,009	1,307	7,547	2,514
Shanxi	2,511.3	3,860.7	170	52,807	50,109	403	583	7,932	2,698
Inner Mongolia	5,011.5	6,202.5	1,083	63,824	59,731		45	3,070	4,093
Liaoning	3,557.7	4,993.1	813	45,020	44,398	877	739	7,643	622
Jilin	3,476.4	3,843.4	1,788	34,516	32,931	354	300	3,632	1,585
Heilongjiang	5,013.2	6,681.1		49,928	49,262	176	356	4,113	666
Shanghai	259.5	400	2,100	4,231	4,227	91	371	843	4
Jiangsu	757	1,442.5	23,939	27,749	26,088	605	2,127	6,833	1,661
Zhejiang	795.1	1,263.5	10,408	40,266	36,136	392	849	3,933	4,130
Anhui	1,833	2815	5,611	40,857	38,701	404	211	5,869	2,156
Fujian	873.9	885.9	3,701	50,202	41,381	144	406	4,328	8,821
Jiangxi	2,161.4	3,458.4	5,537	36,918	25,328	263	15	3,846	11,590
Shandong	2,364.2	3,829.3	2,486	67,847	67,694	1,359	2,255	17,783	153
Henan	2,353.1	4,454.8	1,104	60,330	57,813	465	78	8,548	2,517
Hubei	2,030.7	3071	7,256	55,389	44,120	538	557	7,326	11,269
Hunan	2,306.5	3,339.5	10,065	60,416	32,766	280	204	3,457	27,650
Guangdong	773.5	1,545.4	10,808	95,610	86,123	953	4,989	12,209	9,487
Guangxi	2,012.8	2,432.3	5,582	51,378	43,671	575	389	2,319	7,707
Hainan	219	222.2	414	17,124	13,030	302	74	772	4094
Chongqing	591.4	590.8	2,324	28,086	20,521	134	122	2,328	7,565
Sichuan	2,289.6	2,613.6	6,199	89,318	66,878	747	633	6,580	22,440
Guizhou	1,653.5	1,712.5	2,132	33,973	15,470	115	26	627	18,503
Yunnan	1,872.5	1,931.1	1,530	102,405	95,354	405	72	1,435	7,051
Tibet				22,475	10,582			568	11,893
Shaanxi	1,940.7	2,315.5	998	43,212	36,396	315	159	3,034	6,816
Gansu	2,322.8	3,279.1	1,305	36,212	26,089	13		3,164	10,123
Qinghai	1,091.8	1,097.3	372	18,268	14,549		18	1,394	3,719
Ningxia	711.7	802.2	397	10,015	9,460	55	109	1,367	555
Xinjiang	1,848.5	2,604.8		33,484	31,149	170	57	5,086	2,335

Source: The China Statistical Yearbook, 2000

Appendix 11 Infrastructure 2000 (unit: kilometer)

Region	Length of railways in operation	Extension length of the truck lines	Length of Navigable waterways	Total length of highways	Express way and class I to IV highways	Express way	First class	Second class	Highway below class IV
National	58,655.9	81,736.3	119,325	1,402,698	1,216,013	16,314	20,088	152,672	186,685
Beijing	1,140.9	1,815.3		13,597	13,143	267	298	1,444	454
Tianjin	531.2	962.4	443	8,946	8,869	305	370	1,214	77
Hebei	3,631.9	6,069.3	75	59,152	56,776	1,480	1,458	8,028	2,376
Shanxi	2,510.8	3,860.7	170	55,408	52,767	518	614	8,189	2,641
Inner Mongolia	5,011.1	6,223.7	1,164	67,346	63,622		140	3,865	3,724
Liaoning	3,556.4	5,041.8	813	45,547	44,969	1,068	833	8,347	578
Jilin	3,474.4	3,843.6	1,787	35,216	33,698	354	410	4,150	1,518
Heilongjiang	5,013.2	6,679.3	5,057	50,284	49,622	285	387	4,643	662
Shanghai	256.5	397.2	2,100	4,325	4,325	98	390	982	
Jiangsu	757.1	1,442.6	23,943	28,198	26,564	1,090	2,228	6,999	1,634
Zhejiang	793.7	1,263.4	10,408	41,605	37,707	627	999	4,212	3,898
Anhui	1,842.9	2,877.9	5,611	44,493	42,579	470	264	6,347	1,914
Fujian	873.9	885.9	3,701	51,073	42,512	345	406	4,582	8,561
Jiangxi	2,152.6	3,440.5	5,537	37,138	26,448	414	248	4,568	10,690
Shandong	2,401.6	3,980.6	2,486	70,686	70,579	2,006	2,599	18,885	107
Henan	2,353.1	4,570.9	1,104	64,453	62,192	505	38	9,028	2,261
Hubei	2,030.8	3,070.9	7,256	57,850	48,062	569	611	7,911	9,788
Hunan	2,312.7	3,528	10,041	60,848	33,380	449	239	3,761	27,468
Guangdong	693.8	1,383.6	13,696	102,604	93,693	1,186	5,391	13,396	8,911
Guangxi	2,012.3	2,431.6	5,618	52,910	45,430	812	442	2,628	7,480
Hainan	219	222.2	414	17,401	13,405	601	121	636	3,996
Chongqing	598	597.4	2,324	29,252	21,743	199	123	2,951	7,509
Sichuan	2,333.3	2,622.7	5,980	90,875	69,723	1,000	906	7,451	21,152
Guizhou	1,641.7	1,711.6	2,132	34,643	17,034	258	26	718	17,609
Yunnan	1,872.5	1,931.1	1,580	109,560	102,550	517	77	1,722	7,010
Tibet				22,503	10,647			568	11,856
Shaanxi	2,204.6	2,638.1	998	44,006	37,459	349	175	3,420	6,547
Gansu	2,318	3,274.2	1,306	39,344	29,393	13	75	3,280	9,951
Qinghai	1,091.9	1,097.3	372	18,679	15,178		31	1,806	3,501
Ningxia	716.1	806.7	402	10,171	9,649	83	127	1,530	522
Xinjiang	2,309.9	3,065.8		34,585	32,295	446	62	5,411	2,290

Source: The China Statistical Yearbook, 2001.

Appendix 12 Infrastructure 2001 (unit: kilometer)

Regions	Length of railways in operation	Length of Navigable waterways	Total length of highways	Express way and class I to IV highways	Express way	First class	Second class	Highway below class IV
Total	70,057.2	121,535	1,698,012	1,336,044	19,437	25,214	182,102	361968
Beijing	1,160.6		13,891	13,445	335	294	1,796	446
Tianjin	697.2	443	9,647	9,067	304	404	1,378	580
Hebei	4,570.9	75	62,615	53,257	1,563	1,936	9,259	9358
Shanxi	3,050.2	305	56,993	54,529	584	695	8,444	2464
Inner Mongolia	6,038.2	1,188	70,408	60,234	151	195	4,825	10,174
Liaoning	3,782.8	813	46,603	46,309	1,068	1,025	9,768	294
Jilin	3,561.6	1,787	39,747	36,964	381	723	4,752	2,783
Heilongjiang	5,503.2	5,057	62,979	57,762	414	548	5,638	5,217
Shanghai	256.5	2,032	6,078	5,585	110	413	1,139	493
Jiangsu	897.7	23,902	58,866	48,587	1,387	2,906	10,096	10,279
Zhejiang	1,220.8	10,408	44,005	41,072	774	1,849	5,682	2,933
Anhui	2,220.4	5,611	65,807	59,797	596	300	7,140	6,010
Fujian	1,284.8	3,701	53,547	40,666	364	259	5,514	12,881
Jiangxi	2,415.3	5,537	60,314	35,093	421	314	6,471	25,221
Shandong	2,855.4	2,552	71,128	70,963	2,077	3,000	19,707	165
Henan	3,593.9	1,587	69,041	63,437	1,077	38	12,266	5,604
Hubei	2,212.5	7,256	85,757	66,048	805	812	9,152	19,709
Hunan	2,757.9	10,041	66,593	36,800	585	335	4,705	29,793
Guangdong	1,923.2	13,687	104,798	93,833	1,500	6,003	14,425	10,965
Guangxi	2,710.7	5,582	54,752	40,192	822	449	4,316	14,560
Hainan	219	414	20,667	11,483	574	157	1,243	9184
Chongqing	632.6	2,324	30,654	21,405	320	136	3,127	9,249
Sichuan	2,505.2	7,357	108,724	72,063	1,144	1,435	8,332	36,661
Guizhou	1,643.7	2,132	34,617	24,625	311	71	1,797	9,992
Yunnan	1,946.3	1,824	163,953	106,396	517	164	2,106	57,557
Tibet			35,537	7,196			622	28,341
Shaanxi	2,873.8	1,033	45,273	39,300	543	168	4,697	5,973
Gansu	2,664.8	1,306	39,844	30,283	13	154	4,007	9,561
Qinghai	1,297	372	23,328	17,424	26	55	2,463	5,904
Ningxia	786.6	402	10,899	10,723	240	146	1,677	176
Xinjiang	2,774.4		80,947	61,506	431	230	5,558	19,441

Source: The China Statistical Yearbook, 2002.

Appendix 13 Infrastructure 2002 (unit: kilometer)

Regions	Length of railway in operation	Length of navigator inland waterways	Total length of highways	Express way and class I to IV highway	Express way	First class	Second class	Highway below class IV
National	71,897.5	121,557	176,5222	1,382,926	25,130	27,468	197,143	382,296
Beijing	1,138.1	443	14,359	13,940	463	331	1,822	419
Tianjin	681.6	75	9,696	9,126	331	404	1,408	570
Hebei	4,585.7	305	63,079	53,995	1,591	2,050	9,835	9,084
Shanxi	3,050.5	1,188	59,611	57,250	1,070	734	8,851	2,361
Inner Mongolia	6,192.6	813	72,673	63,000	252	330	6,069	9,673
Liaoning	3,799.8	1,787	48,051	47,769	1,637	987	10,770	282
Jilin	3,561.8	5,057	41,095	38,408	542	1,120	4,918	2,687
Heilongjiang	5,502.8	2,037	63,046	57,882	413	707	5,821	5,164
Shanghai	256.5	23,899	6,286	6,024	240	442	1,203	262
Jiangsu	1,340.4	10,408	60,141	49,959	1,704	3,085	10,637	10,182
Zhejiang	1,300.1	5,611	45,646	42,759	1,307	2,070	5,777	2,887
Anhui	2,219.7	3,701	67,547	61,406	866	300	7,480	6,141
Fujian	1,453.9	5,537	54,155	41,220	583	278	5,573	12,935
Jiangxi	2,368.6	2,552	60,696	36,070	666	314	6,731	24,626
Shandong	2,855.4	1,587	74,029	73,884	2,411	3,521	20,251	145
Henan	3,593.9	7,271	71,741	66,524	1,231	38	15,809	5,217
Hubei	2,388.9	10,041	86,098	67,290	943	822	11,105	18,808
Hunan	2,758	13,687	84,808	38,433	1,012	412	4,958	46,375
Guangdong	2,108.2	5,582	108,538	97,711	1,741	6,255	15,160	10,827
Guangxi	2,745.2	414	56,297	42,155	822	449	4,773	14,142
Hainan	213.9	2,324	20,876	11,775	626	160	1,315	9,101
Chongqing	718.2	7,357	31,060	21,936	399	154	3,383	9,124
Sichuan	2,944	2,132	111,898	73,943	1,501	1,480	8,612	37,955
Guizhou	1,892.8	1,824	44,220	30,504	311	73	2,191	13,716
Yunnan	2,371.4		164,852	107,615	746	164	2,192	57,237
Tibet		1,033	39,760	8,357			611	31,403
Shaanxi	2,885.1	1,306	46,564	40800	576	168	5,109	5,764
Gansu	2,317.4	372	40,223	30,806	320	154	4,134	9,417
Qinghai	1,091.9	407	24,003	18,484	35	59	2,990	5,519
Ningxia	786.6	82,929	11,245	11,081	360	153	1,891	164
Xinjiang	2,774.5	2,807	62,820	431	254	5,764	20,109	

Source: The China Statistical Yearbook, 2003.

Appendix 14 Infrastructure 2003 (unit: kilometer)

Regions	Length of railway in operation	Length of navigator inland waterways	Total length of highways	Express way and class I to IV highway	Express way	First class	Second class	Highway below class IV
National	73,002	123,964	1,809,828	1438,738	29,745	29,903	211,929	371,090
Beijing	1,136.1		14,453	14,139	499	420	1,845	314
Tianjin	666.3	89	10,168	9,901	517	420	1,468	267
Hebei	4744		65,391	55,682	1,681	2,169	10,582	9,709
Shanxi	3,137.5	485	63,122	60,838	1,211	781	9,407	2,284
Inner Mongolia	6,202.6	2,403	74,135	65,157	329	341	6,604	8,978
Liaoning	4,173.9	413	50,095	49,845	1,637	1,100	11,378	250
Jilin	3,561.8	1,444	43,779	41,362	542	1,258	5,625	2,417
Heilongjiang	5,483.7	5,130	65,123	59,599	413	925	6,623	5,524
Shanghai	256.5	2,223	6,484	6,322	240	468	1,534	162
Jiangsu	1,393.6	24,793	65,565	56,300	2,004	3,316	11,287	9,265
Zhejiang	1,249.9	9,892	46,193	43,436	1,438	2,251	5,948	2,757
Anhui	2,219.7	5,586	69,560	63,374	1,070	301	8,198	6,186
Fujian	1,453.9	3,245	54,876	42,222	727	312	5,723	12,654
Jiangxi	2,298.2	5,590	61,233	37,791	1,040	330	7,372	23,442
Shandong	3,150.5	1,012	76,266	76,170	3,018	3,945	20,764	96
Henan	3,654.2	1,208	73,831	68,739	1,418	44	17,853	5,092
Hubei	2,388.5	8,155	87,813	69,914	1,074	876	12,268	17,899
Hunan	2,977.2	11,551	85,233	39,689	1,218	468	5,173	45,544
Guangdong	2,112.5	11,843	110,253	99,733	2,303	6,543	15,926	10,520
Guangxi	2,738	5,413	58,451	45,284	1,011	482	5,351	13,167
Hainan	221.7	343	20,877	11,894	626	172	1,386	8,983
Chongqing	718.2	4,103	31,407	22,562	580	168	3,624	8,845
Sichuan	2,961.8	10,720	112,543	75,290	1,501	1,516	9,190	37,253
Guizhou	1,900.1	3,502	45,304	32,352	323	87	2,616	12,952
Yunnan	2,340.3	2,540	166,133	109,300	1,064	230	2,677	56,833
Tibet			41,302	9,107			611	32,195
Shaanxi	2,892.3	1,065	50,019	44,422	844	187	5,335	5,597
Gansu	2,312.5	860	40,293	30,947	342	154	4,176	9,346
Qinghai	1,091.8	330	24,377	21,568	118	144	3,187	2,809
Ningxia	791.4	26	11,916	11,770	526	142	1,998	146
Xinjiang	2,773.3		83,633	64,029	431	353	6,200	19,604

Source: The China Statistical Yearbook, 2004.

Appendix 15 Regional Average Wage (unit: RMB)

Regions/Year	1996	1997	1998	1999	2000	2001	2002	2003
Beijing	9,579	11,019	12,451	14,054	16,350	19,155	21,852	25,312
Tianjin	7,643	8,238	9,946	11,056	12,480	14,308	16,258	18,648
Hebei	5,286	5,692	6,302	7,022	7,781	8,730	10,032	11,189
Shanxi	5,183	5,320	5,641	6,065	6,918	8,122	9,357	10,729
Inner Mongolia	4,716	5,124	5,792	6,347	6,974	8,250	9,683	11,279
Liaoning	5,269	5,591	7,161	7,895	8,811	10,145	11,659	13,008
Jilin	5,370	5,664	6,551	7,158	7,924	8,771	9,990	11,081
Heilongjiang	4,564	4,889	6,238	7,094	7,835	8,910	9,926	11,038
Shanghai	10,663	11,425	13,580	16,641	18,531	21,781	23,959	27,304
Jiangsu	6,603	7,108	8,256	9,171	10,299	11,842	13,509	15,712
Zhejiang	7,413	8,386	9,759	11,201	13,076	16,385	18,785	21,367
Anhui	5,175	5,492	6,117	6,516	6,989	7,908	9,296	10,581
Fujian	6,684	7559	8,531	9,490	10,584	12,013	13,306	14,310
Jiangxi	4,852	5,089	5,384	6,749	7,014	8,026	9,262	10,521
Shandong	5,809	6,241	6,854	7,656	8,772	10,008	11,374	12,567
Henan	4,924	5,225	5,781	6,194	6,930	7,916	9,174	10,749
Hubei	5,099	5,401	6,436	6,991	7,565	8,619	9,611	10,692
Hunan	5,100	5,326	6,558	7,269	8,128	9,623	10,967	12,221
Guangdong	9,127	9,698	11,032	12,245	13,823	15,682	17,814	19,986
Guangxi	5,397	5,542	6,208	6,776	7,651	9,075	10,774	11,953
Hainan	5,476	5,664	6,248	6,865	7,408	8,321	9,480	10,397
Chongqing	N/A	5,502	6,433	7,182	8,020	9,523	10,960	12,425
Sichuan	5,156	5,626	6,577	7,249	8,323	9,934	11,183	12,441
Guizhou	4,917	5,206	5,775	6,595	7,468	8,991	9,810	11,037
Yunnan	6,231	7,037	7,667	8,276	9,231	10,537	11,987	12,870
Tibet	11,519	10,098	10,987	12,962	14,976	19,144	24,766	26,931
Shaanxi	4,882	5,184	6,029	6,931	7,804	9,120	10,351	11,461
Gansu	5,882	6,182	6,809	7,427	8,560	9,949	11,147	12,307
Qinghai	6,513	7,091	8,011	9,081	10,050	12,906	14,472	15,356
Ningxia	5,635	6,073	6,822	7,392	8,590	10,442	11,640	12,981
Xinjiang	5,987	6,644	7,121	7,611	8,717	10,278	11,605	13,255

Source: The China Statistical Yearbook, various issues.

Appendix 16 Number of Cases for Taiwan Approved Investment in Mainland China by Area, 1991-2003 (unit: case)

Period	1991-1994	1995	1996	1997	1997*	1998	1998*	1999	2000	2001	2002	2003
Guangdong	3,526	114	93	283	3136	274	274	177	288	315	877	1,228
Fujian	1,742	52	66	71	955	59	78	44	32	37	536	522
Guangxi	96	0	1	3	59	2	6	3	2	0	15	19
Hainan	163	1	0	7	126	1	11	4	2	2	5	11
Shanghai	1,224	89	65	105	835	113	65	70	163	297	568	641
Jiangsu	1,137	74	64	103	748	83	63	99	225	314	639	815
Zhejiang	560	27	21	35	412	25	21	27	36	72	171	215
Hubei	120	7	4	6	241	1	20	7	1	14	12	31
Hunan	118	29	3	10	80	2	6	1	1	4	11	11
Chongqing	52	2	1	7	53	1	5	4	1	3	10	14
Sichuan	127	1	4	5	84	9	8	1	4	7	25	19
Beijing	350	23	9	21	191	18	20	22	44	59	78	100
Tianjin	231	16	13	15	397	13	7	8	5	18	38	37
Hebei	151	9	4	8	52	7	4	4	4	3	8	12
Henan	138	4	1	2	40	1	6	1	2	2	10	8
Shandong	348	8	10	16	234	11	18	4	8	11	40	80
Liaoning	213	10	8	9	138	4	7	5	10	9	28	42
Jilin	37	0	0	2	19	1	2	0	1	2	2	1
Heilongjiang	14	5	0	2	9	2	1	0	0	1	0	2
Others	386	19	17	17	170	14	20	5	11	16	42	62

Note:

1. * Figures mean lagged reports and approvals in 1997 and 1998.

2.The figures are not added up to the total due to rounding up.

Source: Investment Commission, the Ministry of Economic Affairs, Taiwan. Statistics on Overseas Chinese & Foreign Investment, Outward Investment, Indirect Mainland Investment, Taiwan, August 2005; Hsu and Liu, 2004

Appendix 17 Taiwan Approved Investment in Mainland China by Area, 1991-2004 (unit: 1000 USD)

Period	1991 -1994	1995	1996	1997	1997*	1998	1998*	1999	2000	2001	2002	2003	2004
Guangdong	146,101	222,748	282,816	540,295	1,180,605	587,224	237,195	500,144	1,019,703	787,972	1,635,093	2,054,475	1,403,080
Fujian	655,969	121,656	110,884	72,973	399,256	91,109	59,684	58,899	99,486	120,122	749,942	491,778	69,923
Guangxi	19254	0	850	833	14,971	980	6,833	279	752	0	53,737	39,079	24,448
Hainan	73016	649	0	3770	34,214	1,161	11,836	388	1,595	2,403	6,260	16,607	3,018
Shanghai	605,103	224,160	243,843	305,851	282,630	226,080	60,212	151,201	321,066	376,244	949,230	110,296	1,174,993
Jiangsu	678,805	170,612	298,148	367,599	291,217	357,536	50,923	323,807	930,557	1,046,346	2,223,082	2,601,103	2,486,757
Zhejiang	204,594	57,425	32,754	82,256	113,021	73,402	12,409	78,984	68,671	208,484	511,553	607,721	689,461
Hubei	44,824	24,436	4,069	3,680	47,026	6,395	25,750	17,797	1,094	28,092	14,785	98,204	115,752
Hunan	34,352	31,563	15,064	4,456	25,392	3,633	1,297	880	160	8,860	12,617	10,580	19,176
Chongqing	10,703	4,200	1,200	22,130	5,825	4,594	1,110	25,454	20,000	8,094	11,775	36,554	7,638
Sichuan	84,078	2,300	11,170	3,597	18,265	11,100	3,343	12,700	6,910	11,133	49,575	26,068	91,778
Beijing	113,443	19,380	18,864	20,361	60,411	44,127	8,374	35,368	50,833	86,918	144,255	113,213	65,205
Tianjin	112,132	53,311	96,204	43,934	78,763	26,924	6,007	15,106	40,830	36,970	89,446	159,127	84,619
Hebei	55,284	10,503	17,835	9,777	20,319	4,794	2,195	6,807	967	1,340	41,574	19,597	12,049
Henan	23,977	2,902	600	271	7,268	150	3,679	135	382	270	11,767	19260	17,260
Shandong	123,651	24,043	43,198	52,481	56,688	59,827	6,293	4,136	12,075	28,263	64,443	107,847	138,452
Liaoning	71,130	36,607	26,269	20,874	32,065	5,756	2,504	4,019	14260	18,185	58,673	55,994	25,301
Jilin	11,307	0	0	697	5,221	735	570	0	120	265	3,372	6,400	8,170
Heilongjiang	5,477	6,932	0	1,100	1,182	84	250	0	0	500	0	493	3,560
Others	152,357	79,286	25,473	57,312	44,153	13,598	14,348	10,436	17,681	13,686	91,819	119,670	108,115

Note:

1. * Figures mean lagged reports and approvals in 1997 and 1998

2.The figures are not added up to the total due to rounding up

Source: Investment Commission, the Ministry of Economic Affairs, Taiwan. Statistics on Overseas Chinese & Foreign Investment, Outward Investment, Indirect Mainland Investment, Taiwan, August 2005; Hsu and Liu, 2004.

Appendix 18 Regional Land Mass (unit: 10000 square kilometers)

Region	Land Mass
Guangdong	17.98
Fujian	12.14
Hainan	3.39
Shanghai	0.6345
Jiangsu	10.26
Zhejiang	10.18
Beijing	1.68
Tianjin	1.1919
Hebei	19.77
Shandong	15.67
Liaoning	14.59
Jilin	18.74
Heilongjiang	45.46
Henan	16.7
Hubei	18.59
Hunan	21
Guangxi	264
Chongqing	8.24
Sichuan	48.5

Source: http://www.stats.gov.cn/tjlj/